

**OVERSIGHT OF THE FINANCIAL
STABILITY OVERSIGHT COUNCIL:
DUE PROCESS AND TRANSPARENCY
IN NON-BANK SIFI DESIGNATIONS**

HEARING
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
AND INVESTIGATIONS
OF THE
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**OVERSIGHT OF THE FINANCIAL
STABILITY OVERSIGHT COUNCIL:
DUE PROCESS AND TRANSPARENCY
IN NON-BANK SIFI DESIGNATIONS**

Thursday, November 19, 2015

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON OVERSIGHT
AND INVESTIGATIONS,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:18 a.m., in room 2128, Rayburn House Office Building, Hon. Sean P. Duffy [chairman of the subcommittee] presiding.

Members present: Representatives Duffy, Fitzpatrick, Hultgren, Wagner, Tipton, Poliquin, Hill; Green, Cleaver, Beatty, and Sinema.

Chairman DUFFY. The Oversight and Investigations Subcommittee will come to order. Today's hearing is entitled, "Oversight of the Financial Stability Oversight Council: Due Process and Transparency in Non-Bank SIFI Designations."

Without objection, the Chair is authorized to declare a recess of the subcommittee at any time.

The Chair now recognizes himself for 5 minutes for an opening statement.

Since the passage of the Dodd-Frank Act, this committee has spent significant time examining the law and considering how to improve its numerous imperfections. Among them, Title I of Dodd-Frank creates the Financial Stability Oversight Council, better known as FSOC, which is tasked with identifying risk to the financial stability of the United States from the distress or failure of large, interconnected bank holding companies and non-bank financial companies.

Section 113 of Dodd-Frank vests the FSOC with the authority to determine whether non-bank financial companies should be subject to heightened prudential standards and supervision by the Federal Reserve. Dodd-Frank rewarded the very regulators that missed the warning signs leading up to the 2008 financial crisis with additional power and responsibility with the creation of the FSOC.

By design, the FSOC was intended to facilitate dialogue amongst the Federal financial regulators. While seemingly rational in theory, in practice it has enabled the Treasury Secretary to override the jurisdiction of Federal financial regulators and weaponize the concept of risk management. Moreover, the FSOC and its actions

are riddled with opacity and uncertainty, despite continued requests for information from Congress, and specifically from this committee.

Aside from operational and process concerns, FSOC's SIFI designation may be unconstitutional because they violate due process requirements and legislative nondelegation principles.

Companies designated as SIFIs under the FSOC's informal adjudication process are denied access to records and given little to no guidance about the process and prospects for the respective examinations. For non-banks, there are no defined designation thresholds, no definitions of how designation factors are weighed against each other, and no disclosure by the FSOC of prior designation precedents.

The designation process is wholly subjective and casts data history and economic analysis aside. The FSOC bases its designations on highly speculative worst-case scenarios to justify its expansive regulatory agenda.

Additionally, the non-bank SIFI designation process violates separation of power requirements. FSOC officials who investigate a company and propose a designation also conduct the evidentiary hearing and issue the final designation. This makes the members of the FSOC the judge, the jury, and the executioner.

Once designated, there is no clear path for a company to appeal or to seek de-designation.

Further, the FSOC has highly politicized their regulatory process by concentrating authority in the hands of FSOC members. FSOC members are all Presidentially-appointed leaders of regulatory agencies.

The closed-door nature of FSOC's operations strips authority from the other commissioners of multimember agencies who are part of the agency's bipartisan commission structure. The individual agencies that constitute FSOC are not properly represented on the Council and are limited in their access to information.

Rather than leveraging the expertise of the regulators having primary responsibility for particular industries in the financial system, the FSOC's voting structure makes it possible for FSOC members who know little or nothing about systemic risk in these markets to vote on questions affecting an entire industry.

While cross-border regulatory coordination is critical to the safety and soundness of our global financial markets, the relationship of the FSOC and the Financial Stability Board (FSB) still remains unclear. The FSOC has followed the lead of the FSB on money market funds, on the designation of AIG, MetLife, and Prudential, and asset managers.

The goal of international coordination has turned into an apparent outsourcing of U.S. regulation to the FSB.

Wholly capitulating to the whims of the FSB is inconsistent with congressional intent, puts the U.S. financial system at risk, and curbs any competitive advantage of our domestic companies.

So today, I look forward to our witnesses and hearing their views and perspectives on the constitutionality of the FSOC's actions, lack of due process, and transparency concerns in the FSOC's non-bank SIFI designation process.

With that, I recognize the gentleman from Texas, Mr. Green, the ranking member of the subcommittee, for 5 minutes.

Mr. GREEN. Thank you, Mr. Chairman.

I thank the witnesses for appearing, as well.

And, Mr. Chairman, I would properly label this hearing, “the MetLife Hearing.” It appears to me that we are going to be abundantly fair and make sure that MetLife has a fair hearing, but I see a double standard.

I see a double standard because in 2001, when women brought a gender discrimination lawsuit against MetLife, it was not litigated in Congress; it was litigated in court. When employment discrimination lawsuits have been brought against MetLife, they have not been litigated in Congress; they were litigated in court. When disabled persons filed lawsuits against MetLife, they were not litigated in Congress; they were litigated in court.

And the day before MetLife sued in the current litigation that it has in the D.C. court, MetLife was sued for having what has been called a shadow insurance practice. That will be litigated in court. It will not be litigated in the Congress of the United States of America.

There is a double standard. If you are a hardworking American and you have litigation, you will go to court, you will have to hire your lawyers, and you will have to defend. But if you are a \$900 billion company, you can file your case in the Congress of the United States of America.

Some would say, “But how do you know they asked for this?” If they didn’t ask for it and they are getting it, I think it makes it even more egregious that we would, of our own volition, decide that we are going to make sure MetLife gets a fair hearing.

I thank God that there are Federal courts, and those Federal courts are going to hear the case, at least one in particular. And you can’t intimidate Federal judges. Federal judges have lifetime appointments.

So I just hope that we in the future can be as fair to hardworking Americans, people who find themselves in need of some assistance, that we can be as fair to them as we will be to MetLife.

Case in point: The ranking member and I sent a letter to the Chair of this subcommittee and the Chair of the full Financial Services Committee, asking for a hearing concerning allegations of discrimination in a major financial institution. And when we sent that letter we did it in good faith, assuming that since we were having discrimination hearings, we would have a discrimination hearing with reference to the allegations of discrimination at this major financial institution.

It turns out that we couldn’t do that. We received a letter back from my colleagues—whom I love dearly, by the way—Mr. Hensarling and Mr. McHenry at the time; not you, Mr. Chairman. But it reads in part, “We trust that the reason you elected not to investigate these matters when you controlled the House is because you believe, as we do, that Congress should not exercise its investigative prerogatives with respect to matters of fact and law that are currently being adjudicated in Federal court,” somewhat similar to what we are encountering today.

MetLife down the street in a D.C. court case that we were asking about was in court. MetLife has its case litigated before the Congress of the United States of America. Hardworking Americans with allegations of discrimination can't get such a hearing.

But, now there is an exception. If you happen to be the Consumer Financial Protection Bureau, aka the CFPB, you can have your witnesses come over and have allegations of discrimination leveled against you because that is the agency that is designed to protect the consumer, and there are people who want to eliminate that agency. So it is okay to make allegations of discrimination with reference to them, but not with reference to these major financial institutions.

Okay, there has been the allegation made that, "We don't regulate these major banking institutions." Interesting point, given that we have something called a Financial Services Committee and a Financial Institutions Subcommittee. It just seems to me that it would be something we would look into.

I will have more to say on these points, and I yield back the balance of my time, Mr. Chairman, and I thank you.

Chairman DUFFY. The gentleman yields back.

The Chair now recognizes the gentleman from Pennsylvania, Mr. Fitzpatrick, for 1 minute for an opening statement.

Mr. FITZPATRICK. Thank you, Mr. Chairman.

Transparency and government accountability is what sets the United States of America apart from most other countries in the world. It allows democratically elected representatives to ensure government entities are acting in the best interest of the American people, and also gives us the ability to communicate what is happening back home to our constituents.

Transparency also allows Congress to discover shortcomings and make necessary changes when necessary. However, albeit slowly, Congress is coming to the same conclusion that my constituents back home in Bucks County discovered a long time ago: government is too big; government is too opaque; and government is increasingly unaccountable to Congress.

The CFPB and the FSOC are two examples of this type of runaway bureaucracy, which has enabled government to regulate our financial decisions, limit choices, threaten our capital markets, and suppress economic opportunity for many American families.

I look forward to the testimony from our witnesses, and I hope that this committee can find honest and legitimate ways to bring more transparency to our system, and be more accountable to Congress while encouraging growth and innovation in every sector of our economy.

I yield back.

Chairman DUFFY. The gentleman yields back.

I now want to welcome our distinguished panel.

By way of a brief introduction, first, we have Professor Jonathan Macey, the Sam Harris professor of corporate law, corporate finance and securities law at Yale University.

Second, Professor Hal Scott, the director of the program on international financial systems at Harvard Law School.

Third, Mr. Adam White, a visiting fellow at The Hoover Institution, where he researches and writes on the administrative state and the courts.

And finally, we have Professor Robert Hockett, the Edward Cornell professor of law at Cornell Law School.

Thank you all for being here. Each of you will be recognized for 5 minutes to give an oral presentation of your testimony.

And without objection, all of your written statements will be made a part of the record.

Once the witnesses have finished their testimony, each member of the subcommittee will have 5 minutes within which to ask the panel questions.

Now, please note on your table you have three lights: one is green; one is yellow; and one is red. Yellow means that you have 1 minute left. Red means your time is up.

The microphones are very sensitive, so please make sure that you are speaking directly into them.

With that, Professor Macey, you are now recognized for 5 minutes for a summary of your testimony.

STATEMENT OF JONATHAN R. MACEY, SAM HARRIS PROFESSOR OF CORPORATE LAW, CORPORATE FINANCE AND SECURITIES LAW, YALE LAW SCHOOL

Mr. MACEY. Thank you very much. It is an honor to be here.

Thank you, Chairman Duffy and Ranking Member Green. I appreciate the opportunity to speak to you today.

In evaluating the work of the Financial Stability Oversight Council, I think it is very easy to summarize the problem that we are facing, which is that the FSOC has been given an impossible task and they are performing that task very poorly. What I mean by that is they are asked to regulate something, which is called "systemic risk," that they are unable to define.

And therefore, it is not a very big surprise that they have been unsuccessful in coming up with regulations that provide basic protections for regulated entities, such as objective regulations, non-idiosyncratic or non-ad hoc regulations.

The problem is, I think, very significant. It doesn't mean that regulation should not be attempted at all. Systemic risk, despite our inability to define the term with any precision, is still an important risk, and things like asset bubbles and cascade effects are, as we saw in the financial crisis that began in 2007, a significant source of concern.

Even with that obstacle, though, the major point that I would like to share with you today is that I think we can do significantly better than we are doing. There are a couple of problems that I think should be focused on, and I think this is a very good start in beginning that focus.

I think it is useful to think about this regulatory problem from the perspective of the FSOC. And if you will allow me to make the academic assumption that the FSOC is not perfect, then I will say that in designating an institution as systemically important, there are basically two kinds of errors that the FSOC can make.

One is what statisticians call a type one error, which in essence would be to say that a financial institution is not systemically im-

portant when that financial institution actually is systemically important.

The second kind of mistake that might be made by a regulator or bureaucrat is what is called a type two error, which is simply saying that a financial institution is systemically important when the financial institution, in fact, is not systemically important.

And the problem there is that from the standpoint of the regulator, there are no consequences to making a type two error. There are no consequences to saying, "You—this financial institution, whether it is MetLife or GE Capital or AIG—are systemically risky and pose systemic risk, when in fact, it is not. The only consequence is less competition, higher prices for consumers, and the like.

On the other hand, a type one error, which is to fail to give a systemic designation to an institution that is systemically important, would be catastrophic to the career of a regulator.

So it isn't at all surprising—we should expect and we should plan our regulatory policy around the fact that the game is going to be tilted dramatically in favor of the over-designation of institutions as systemically important.

The second point that I want to make in closing is that the concerns that we have on the basis of the record thus far, with respect to the actions that the FSOC has already taken, is that there is a significant danger of increasing, rather than decreasing, systemic risk. And the reason for that is because the narrow criteria that are used and the fact that the FSOC is ignoring certain risk-reduction strategies is going to herd entities into particular risk strategies and undermine the diversification of risk avoidance strategies that will reduce systemic risk, and we are losing that by the one-size-fits-all approach that has been taken to designations thus far.

Thank you.

[The prepared statement of Mr. Macey can be found on page 56 of the appendix.]

Chairman DUFFY. Thank you, Mr. Macey.

The Chair now recognizes Mr. Scott for 5 minutes for a summary of his testimony.

**STATEMENT OF HAL S. SCOTT, PROFESSOR AND DIRECTOR,
PROGRAM ON INTERNATIONAL FINANCIAL SYSTEMS, HAR-
VARD LAW SCHOOL**

Mr. SCOTT. Thank you, Chairman Duffy, Ranking Member Green, and members of the subcommittee, for permitting me to testify before you today. I am testifying in my own capacity and do not purport to represent the views of any organizations with which I am affiliated, although some of my testimony is consistent with the publicly stated views of the Committee on Capital Markets Regulation, which I direct.

I want to focus on three points in my testimony today.

First, FSOC is an inadequate substitute for real reform of the regulatory structure, which is itself badly needed. Second, FSOC's principal role to designate non-banks as systemically important financial institutions (SIFIs) is ill-advised. And third, the non-bank SIFI designation process should be revised to provide the public

and the potential designee with adequate transparency, including a cost-benefit analysis.

The U.S. financial regulatory structure is highly fragmented and ineffective, as multiple agencies have responsibilities for the same or closely related entities and markets. Following the 2008 crisis, other leading financial centers, including the United Kingdom and the European Union, reorganized and consolidated their regulatory structure. The United States did not.

The FSOC authority to coordinate this fragmented regulatory structure is severely limited.

First, while FSOC has the authority to mediate disagreements between its members, this requires an affirmative vote of two thirds of the members of FSOC. Even if FSOC is able to make recommendations about what to do about problems, it has no mechanism for enforcing them.

Second, a simple majority of FSOC members can recommend that another agency, one of its members, issue a specific rulemaking if FSOC determines that such a rulemaking is necessary to mitigate risk to the financial system. However, FSOC does not have the authority to require agencies to actually implement these rulings.

So its ability to coordinate this fragmented regulatory structure is highly limited.

Let me turn to SIFIs.

One key point is that there is no evidence for the principle underlying SIFI designations: that large financial institutions are so interconnected to each other that the bankruptcy of one will directly cause the bankruptcy of others.

In the 2008 financial crisis, no large financial firms failed as a direct result of their exposures to Lehman Brothers. And analyses show that direct losses due to the failure of AIG would also not have caused the bankruptcy of its large counterparties. They limited their risk at AIG, as prudent counterparties do.

Instead, in 2008 systemic risk existed due to contagion, which is an indiscriminate run by short-term creditors across the entire financial system. Thus, designating certain large non-banks as systemically important and then subjecting these institutions to more stringent regulation does not meaningfully reduce systemic risk.

It also potentially increases moral hazard and could introduce competitive distortions into the marketplace if these designees enjoy reduced funding cost, a subject of some debate.

Finally, the non-bank SIFI designation process is also in need of reform. Currently, the general public and potential future designees, or ones that have been, in fact, designated, receive inadequate information regarding the basis for FSOC's determination.

FSOC does not conduct a cost-benefit analysis when making a non-bank SIFI designation, and the potential designee does not receive an opportunity to present its position to FSOC until FSOC is nearly complete with its process. Furthermore, FSOC does not provide the designee with the opportunity to review the record upon which its decision is based.

These inadequacies in the process should be corrected by the FSOC. And if FSOC does not do so, then Congress should revise

the Dodd-Frank Act so that FSOC is statutorily obligated to provide such transparency.

Thank you, and I look forward to your questions.

[The prepared statement of Mr. Scott can be found on page 71 of the appendix.]

Chairman DUFFY. Thank you, Professor Scott.

Mr. White, you are now recognized for 5 minutes for a summary of your testimony.

**STATEMENT OF ADAM J. WHITE, VISITING FELLOW, THE
HOOVER INSTITUTION**

Mr. WHITE. Thank you.

Chairman Duffy, Ranking Member Green, and members of the subcommittee, thank you for inviting me to testify today.

As my fellow panelists and others have observed, FSOC raises significant concerns in the manner in which it conducts its business: its severely narrow view of due process; its reliance on secret evidence; its preference for perpetual regulation instead of a regulatory off-ramp; and, perhaps most disconcertingly, its stretching of the statutory text to empower itself to designate SIFIs without any consideration of the plausibility of the risk scenarios at issue.

As the FSOC's independent member with insurance expertise said, in dissenting on the MetLife designation, "FSOC has created an impossible burden of proof for companies to meet, as it effectively requires companies to prove that there are no circumstances under which the material financial distress of a company could pose a threat to the financial stability of the United States." He added, "It remains to be seen whether this approach is legally tenable."

These are all serious concerns. But in pursuing reform, it is crucial to keep in mind that the problems we are discussing today are really symptoms of more fundamental structural concerns—namely, the breadth of power that Dodd-Frank gave to the FSOC, and the dearth of structural constitutional checks and balances that would otherwise limit and guide the FSOC's exercise of this power.

Ultimately, the Constitution and administrative law strike a balance between efficiency and procedural rights, between powers and protections, between action and deliberation. That is why the Administrative Procedure Act's (APA's) original sponsor in 1946 called it a regulatory bill of rights, not a bill of powers.

Or, as the Chief Justice wrote for the Court a few years ago in striking down a similar part of Sarbanes-Oxley, "Convenience and efficiency are not the primary objectives or the hallmarks of democratic government." What he meant was efficiency is important, but checks and balances are indispensable.

With all due respect to the ranking member, I would urge against thinking of this hearing as "the MetLife hearing" because the issues we are discussing today are of importance far beyond just the FSOC and the companies that it designates.

These decisions also affect companies that compete with designated SIFIs—companies including community banks and other smaller financial institutions. It also affects the public, who is injured no less than the companies being designated by the FSOC's insistence upon secrecy.

The FSOC, like other parts of Dodd-Frank, the Affordable Care Act, and Sarbanes-Oxley, are not simply new iterations of the same old regulatory arrangements we have had since the New Deal. They go beyond that old paradigm in terms of the agency's powers, their tactics, and their independence from Congress.

It is crucial that Congress reform these structural problems now before these new agency structures become the administrative state's new normal, the regulatory paradigm for decades to come.

Thank you.

[The prepared statement of Mr. White can be found on page 84 of the appendix.]

Chairman DUFFY. Thank you, Mr. White.

And Mr. Hockett, you are recognized for 5 minutes for a summary of your testimony.

**STATEMENT OF ROBERT HOCKETT, EDWARD CORNELL
PROFESSOR OF LAW, CORNELL LAW SCHOOL**

Mr. HOCKETT. Thanks so much for inviting me here today. It is a pleasure to be here and an honor, as well.

So, Ranking Member Green issued me a challenge when he walked in this morning. He said, "I would like to see you condense that lengthy written testimony of yours into 5 minutes."

My friend Jon Macey said, "Yes, I would like to see that."

So watch this.

Basically, the simple point I want to make is that the FSOC, I think, is best regarded as a pragmatic and sort of quintessentially American way of dealing with two particular dilemmas. One of those dilemmas is very longstanding, and the other one is of more recent vintage.

The longstanding one is how to reconcile efficient governance on the one hand with fundamental constitutional values and constraints on the other. This is not a new dilemma by any means. The United States began to encounter it or began to experience it in the late 19th Century as the economy began to grow by leaps and bounds, became more complex, more dynamic, changing much more rapidly than it had done previously.

What that meant, of course, is that it was much more difficult for Congress alone to sort of handle problems, or for the President's sake alone or with a very small Cabinet, to handle problems that might emerge.

If a new form of fraud or a new form of artifice were to emerge, let's say, every month or every couple of months, one couldn't well expect Congress to come into session to legislate some sort of rule against this new form of fraud say every week, or every month, or even every year necessarily, because, of course, Congress has many fish to fry.

So the idea then, of course, was that, maybe what we can do is delegate some of that authority to Executive Branch agencies since the Executive Branch is, after all, there to enforce the laws that Congress enacts.

Now, the sense in which this gave rise to a problem, of course, is that that can lead to an agency seeming to be engaging not only in enforcing the laws, not only, in other words, in discharging Executive Branch functions, but it would seem also to be engaging in

some form of legislation or quasi legislation, for example, if it was enacting rules to sort of fill in gaps that statutory language left open.

By the same token, if an agency decided to deliberate in some sort of formal way before deciding to take some form of enforcement action against some accused perpetrator of some infraction, that could look like a kind of adjudication and that would then mean that we were sort of muddying the waters, essentially muddling the distinctions between Article One, Article Two, and Article Three functions.

So the big question, then, was how do we reconcile, on the one hand, this need for government efficiency, with these constitutional constraints on the other hand. And the answer that we came up with—it took a while, of course, to get there, but it is largely codified, it is largely embodied in the APA that my friend Mr. White just mentioned.

And I am going to submit to you that the way the FSOC conducts its operations is entirely in keeping with APA norms, and APA values. It is not in any sense an outlier when it comes to regulators. There are countless regulators that act exactly as FSOC does in particular respects that people have called into question. And if you give me the opportunity during the Q&A, I would be happy to adduce examples.

The second dilemma that I mentioned as sort of a more recent vintage is reconciling regulatory depth, say, with regulatory breadth, particularly in the financial sphere.

So what do I mean by that? As you know, and as many people have noted, our financial regulatory system is very siloed, very much fragmented. And the reason for that is that at one time our financial system was very much siloed and very much fragmented.

In other words, they were quite distinct, quite categorically distinct subsectors of the financial sector. And so it seems to make sense to have a specific regulator for each of those subsectors; that way, each regulator could get to know the field of its regulation in depth, right?

The problem, of course, was that beginning in the 1980s and really accelerating over the course of the 1990s, we began to experience a form of what is known as financial convergence. And what that means is basically two things. It means on the one hand, institutions that used to be categorically distinct—like insurance companies on the one hand, commercial banks on the other—began to engage in some very similar-looking transactions, right?

Convergence also could be understood in a more institutional sense. And what that means is you actually found institutions affiliating under a single holding company or conglomerate structures.

That, of course, presented a new challenge. If you think about it, one thing that has not been mentioned here yet is that MetLife was a bank holding company as recently as 2012, and it failed stress tests that were conducted when it was a holding company. This is just one example, but it shows you the sense in which you can't draw the same categorical distinctions.

FSOC is a way of trying to kind of keep sector-specific regulators on the one hand, but to get regulatory breadth on the other by joining them into a council.

Thank you very much.

[The prepared statement of Mr. Hockett can be found on page 32 of the appendix.]

Chairman DUFFY. Very impressive, with about 5 seconds to spare, Professor Hockett.

Mr. HOCKETT. Thank you, Mr. Chairman.

Chairman DUFFY. Without objection, the Chair would like to submit for inclusion into the record a written statement from Peter Wallison and Arthur Burns, fellows in financial policy studies at the American Enterprise Institute, on the troubling interactions between the FSOC and the Financial Stability Board.

Without objection, it is so ordered.

The Chair now recognizes himself for 5 minutes for questions.

I want to be clear: This is a hearing about the FSOC. This is not a hearing about discrimination. We have had those hearings and we may have more.

This is not a hearing about anyone who has been designated. This is about the process, and I want to be clear on that.

I don't think FSOC is being litigated in the Federal courts. But it is a role for Congress to look at the structure of FSOC and how well it works or how well it doesn't work.

So with that in mind, Dodd-Frank implicitly provides that any hearing by FSOC would be an informal adjudication under the Administrative Procedure Act. And as a result, FSOC could base its decision to designate a company on materials that aren't part of the hearing record.

Thus, FSOC could designate the company on the basis of evidence not subject to adversarial scrutiny by the company in its hearing itself. I think this potentially undermines the reliability of the designation process.

And so with that, Mr. White, is it fair to go through this kind of a process without being able to confront the evidence in a hearing for a company who is potentially going to be designated?

Mr. WHITE. No, I don't think it is fair. As you indicated, the best test of fact is to try it from both sides and both directions. The adversarial process has been key both in the courts and also in administrative procedures.

The courts have recognized limited instances in which it is okay for an agency to withhold evidence when national security is truly at stake, but nothing as far as I can tell—and, of course, I don't have access to the full record—in the FSOC procedures so far seem to justify the withholding of evidence. It injures the public.

Chairman DUFFY. And so what would be the—what is the benefit? If there is no national security interest in withholding that evidence, why couldn't FSOC present all of the evidence in these hearings to the subject company and let them confront it? Is there a good reason why they wouldn't allow all the evidence to be shown?

Mr. WHITE. As far as I could tell, no. I think they should show all the evidence, both for the benefit of the designated company and for the public at large.

Chairman DUFFY. And is this a good way to identify systemic risk?

Mr. WHITE. No, I don't think it is.

Chairman DUFFY. Okay.

And again, maybe to Mr. Macey or Mr. Scott, is this a fair way to hold a hearing?

Mr. MACEY. I wrote an amicus brief in the ongoing litigation regarding MetLife's designation as a non-bank SIFI, and I wasn't even able to obtain access to the actual basis for the decision, putting aside the supporting documents. There is a public version of the rationale, and then there is a version that the public is not permitted to see even of the rationale that presumably adduces the evidence.

So I think it is unfair, but it is also perplexing as to what is their motivation.

I just would add simply that I think this is a significant problem. I think that it is a symptom of a much broader problem, which is that when someone is under scrutiny—when a company is under scrutiny for potentially being—or being accused, if you will, of being systemically important, it is counterpunching—it is fighting against a moving target. There are no established criteria. There is nothing that the firm can do in order to make a convincing argument because there are no rules.

And so we have—the role played by evidence is very unclear because evidence is generally adduced so that you can show something. Here we have evidence being adduced for no clear reason other than apparently to support a conclusion that has already been made by the regulators, which is certainly what appears to be the case in the designations we have observed thus far.

Chairman DUFFY. And my time is almost up.

One other quick question: Does it present any concern for the panel when you have, say with the designation of a MetLife or a Prudential, where you have the one FSOC member who has expertise in this area who votes no, and everyone else really without any expertise is voting yes, that those who have expertise are going against the grain of the rest of the FSOC members?

Does that pose a concern, maybe, Mr. Scott, to you or Mr. White?

Mr. SCOTT. It is a concern, obviously, that the person with the most expertise thinks it is ill-advised. Of course, one has to be careful because that person could be seen as a representative of the insurance industry, in this case.

So I think the deeper problem is having votes by committee on such a matter. If you are going to engage in this process, it doesn't seem it should be subject to a vote, which includes, by the way, people on that committee who have no knowledge of this industry—none.

You could argue that the SEC has some knowledge of the capital markets and therefore some knowledge of what the insurance industry is all about. I think it shouldn't be just left to the insurance regulator, because the designation has an impact on the entire financial system.

So I think it is a concern, but it is a reflection of a deeper problem.

Chairman DUFFY. And, Professor, my apologies. I asked you a question as I was running out of time. So thank you for your answer, but I am a minute over.

So with that, I will recognize the gentleman from Missouri, Mr. Cleaver, for 5 minutes.

Mr. CLEAVER. Thank you, Mr. Chairman.

About 3 years ago, my daughter married a guy who had just graduated from the K.U. Law School, and as a Missourian you have to understand, which I know that my colleague and friend from St. Louis, Mrs. Wagner, understands, that this is serious business if you live in Missouri. It is almost betrayal.

And for people around the country who are probably unaware of the rivalry between Missouri and Kansas, I will just tell you very quickly that a few years ago K.U. won the national basketball championship, and Ike Skelton was the dean of our delegation, and as Members were asked to stand, Ike Skelton told the Missouri delegation not to stand. Now, he was considered to be one of the last gentlemen of the Congress, but that will get to it.

But let me now say that we are proud in Missouri to have Professor Hockett here with us, who is a K.U. Law School graduate.

And so times have changed, and we are very thrilled and proud of you, and claim you from your base in Cornell. So thank you very much.

Professor Macey, one of your criticisms of the FSOC is that the Council does not distinguish plausible risk from implausible, so what is likely to occur, rather than what could occur. Maybe you have a stop sign, there is a possibility that could be an accident. That is why you have the stop sign.

And so I am a little concerned about and hopeful that you can provide me with some more information on this whole issue. FSOC doesn't have as its purpose to examine what could occur so that potential—they are trying to find ways in which bad things don't happen again to the American public.

I will remind everybody that the reason we have FSOC is because we discovered in this very room back in 2008 that we had lost about 9 million jobs and about \$20 trillion in household wealth—\$20 trillion. And so we took this action, and I am pleased that we did so. But the criticism sometimes, I think, forgets about that.

So can you please help us understand your statements concerning risk?

Mr. MACEY. Certainly, Congressman. I very much appreciate the question and the opportunity to respond.

Basically, my concern is that it is an elemental characteristic of risk regulation of any variety that the two vectors along which an analysis must occur are: one, the severity of the event about which one is concerned, the severity of a systemic event; and two, the probability that particular factors will cause that event to occur.

And the basic insight is that if regulation were free, then we would regulate everything and have no risks whatsoever. But regulation is costly if we want to—we could vastly reduce the number of fatalities on the highway if we required everyone on the highway to drive a tank instead of an automobile, but there would be a cost to doing that.

The same thing is true with risk regulation.

What is of concern to me is that in its explanation of the basis of its final determination with respect to MetLife, the FSOC specifically asserted that because the statute—because Dodd-Frank does not expressly incorporate a standard of likelihood, the FSOC may assess harm to the financial stability of the United States based on risks that lack even basic plausibility—

Mr. CLEAVER. I hate to—

Mr. MACEY. —context.

Mr. CLEAVER. I apologize, but I only have 16 seconds and I am just interested, what would you assign as a probability for another 2008 crash?

Mr. MACEY. I'm sorry, another what?

Mr. CLEAVER. Probability.

Mr. MACEY. I know, a probability of what? I didn't hear—

Mr. CLEAVER. Of another 2008 economic collapse?

Mr. MACEY. In the next week, or year, or—

Mr. CLEAVER. I will finish, but as I understand, maybe Mr. Green and I are the only ones who were here; 4 months before we had the crash, we had the credit rating agencies in this committee hearing room—

Mr. MACEY. Okay.

Mr. CLEAVER. —telling us everything was great.

Mr. MACEY. Right. Yes, I am aware of that.

I think that there is a reasonable probability. Let's take a 5-year time horizon. I would say that there is a reasonable probability: less than 50 percent but greater than 10 percent.

As I said in my original testimony, I think that certain aspects of Dodd-Frank have increased, unfortunately, rather than decreased the probability of that occurring because of herding effects and the like.

I certainly don't think it is the case that we have eliminated systemic risk. The problem of asset bubbles remains. Many other problems remain. So I think there is some reasonable probability.

I wish I could be more precise than that, but I am doing the best I can for you, sir.

Chairman DUFFY. The gentleman's time has expired.

The Chair now recognizes the Vice Chair of the subcommittee, the gentleman from Pennsylvania, Mr. Fitzpatrick, for 5 minutes.

Mr. FITZPATRICK. I thank the chairman for the recognition.

And as a matter of history, right before the 2008 crisis, we also had Fannie Mae before the committee, who also said everything was great right before they required about \$180 billion in resources to sort of stand up that organization and likely—and it has been written extensively about—had more to do with housing policy and what was happening. There certainly were problems within the banking sector, but housing policy, in my view, had much more to do with it.

I thank the witnesses for their testimony here today.

Professor Macey and Professor Scott, I want to ask you about a specific section of Dodd-Frank, Section 113, which lays out 10 factors that FSOC is required to consider when evaluating a non-bank entity company for SIFI designation.

Does the FSOC explain how it uses the 10 factors when it issues the designation? For instance, does it explain how it weighs those factors? And specifically, when it is weighing those factors, is it considering, as it is thinking about those factors, whether a particular company is at risk or in distress, or is it just assuming the company is going to fail or the company is at risk and how those 10 factors then would—and that bank's or the non-bank's company would—how their failure would affect the economy?

Am I clear on that question?

Mr. SCOTT. The short answer is “no.” I do think, however, that in general—that is “no” with respect to any particular designation. There is a general methodology that FSOC has about the use of these factors, which uses similar factors to those of the Financial Stability Board. So these factors actually emerge out of a more general G-20 consensus.

But the application of these factors and how much they weigh those factors on any specific determination is not revealed by FSOC.

And I would just add, going back to my oral testimony, that all of these factors are aimed at the idea of connectedness. So, for instance, one of the factors is how interconnected is a particular institution to somebody else. All financial institutions are very interconnected in a sense, but that doesn't prove that if one financial institution would fail, its counterparties would fail, which is the real concern about interconnectedness.

So they don't demonstrate is that interconnectedness really important? If there were a failure, what would the consequences be? That is what we really care about, and they don't do that.

So I would say, again, the short answer to your question is no, they don't.

Mr. FITZPATRICK. But isn't it true, Professor Scott, that banks pose a special risk because of their interconnectedness? Do insurance companies or other financial non-bank companies pose that same sort of interconnected risk that you are talking about?

Mr. SCOTT. They are connected, Congressman, obviously. We have an integrated global financial system. People do business with other financial firms. That is connectedness.

But that doesn't provide the justification for singling out a firm and saying, “You are connected, therefore we are going to impose more capital on you,” or we don't even know what we are going to do to you, which is another issue. We don't even know what the consequence of this designation is.

But just to say people are connected is to say, they are financial firms. Yes, they are all connected.

But why do we care about that? Why is that important? Is it at the level—which is what we should care about—if they fail, that other firms will be severely affected?

Now, back to the Congressman's point, sure, if MetLife or a big firm failed, there would be a tremendous economic impact. I don't—clear argument, okay? You could say that about a lot of firms in our economy.

So I don't think we are going around designating firms as important whose failure would affect the economy. The focus here is the

financial system and what the impact would be on the failure of MetLife to the rest of—

Mr. FITZPATRICK. Professor Macey?

Mr. MACEY. I largely agree—

Mr. FITZPATRICK. Can you turn your microphone on?

Mr. MACEY. I largely agree with Professor Scott.

Just to provide another example, it would be—one could observe two financial institutions and one could say on a—during a particular day these financial institutions consummated 50,000 transactions with one another and had 87,000 electronic messages with regard to trading actions, and therefore these institutions are very interconnected.

But as Professor Scott's point indicates, that doesn't tell us anything about whether the failure of one of these would result in the failure of another. One would need to know a lot more about the balance sheet of the entity; one would have to know about how the clearing and settlement is done, what the netting is done.

And so, I think your point is exactly right, which is that it is—there is no weighting and there is no indication of how the criteria should be used properly, which is to say how are the—how are these criteria related to systemic risk as opposed to just existing in some form that is really very benign?

Mr. FITZPATRICK. I am out of time. I appreciate the witnesses' views.

Thank you.

Chairman DUFFY. The gentleman yields back.

The Chair now recognizes the gentlelady from Missouri, Mrs. Wagner, for 5 minutes.

Mrs. WAGNER. Thank you all for joining us today to discuss the process by which FSOC designates non-bank firms as systemically important.

Such a process goes far beyond the companies that are being designated, as these designations have a far-reaching impact on the broader economy, as we have discussed, and millions of customers who would be affected.

According to research, designating asset management firms as SIFIs could ultimately cost as much—investors who rely on those services as much as 25 percent of the return on their investments over the long term, which is approximately \$108,000 per investor. In addition, designating insurance companies as SIFIs could reduce consumer benefits, increase prices, and make some products no longer available.

Mr. White, Dodd-Frank does not require the FSOC to justify its SIFI designations by demonstrating that the designated financial company poses a substantial likelihood of causing systemic financial harm. Rather, it allows the FSOC to designate a financial company as a SIFI if it merely could pose a threat to the financial stability of the United States. In that way, FSOC can present certain cataclysmic events as a model no matter how unlikely they are.

Do you think that FSOC needs to show actual significant risk of systemic financial harm in its designations, sir?

Mr. WHITE. Yes. I think it is the best reading of the law. And to the extent that courts ultimately disagree, I think it is incumbent upon Congress to place that standard on the FSOC.

Mrs. WAGNER. In a way, don't you think that FSOC considering unlikely yet cataclysmic events in a way takes away focus from actually observing legitimate systemic risk existing in the market?

Mr. WHITE. Yes, I do. And if I may expand on this point for just a moment, I don't mean to understate the difficulty of the task for the FSOC in terms of trying to regulate against these uncertain risks in what Secretary Rumsfeld once called the "unknown unknowns," or Nassim Taleb called "black swans." I don't want to underestimate that.

But the task should then fall to Congress, really, to deliberate on this to identify more specific standards for the agency and then set the regulators forward to execute them within clear legislative limits. Then, the courts can enforce those limits.

Mrs. WAGNER. I agree, and I think that it is the entire point of FSOC in the first place.

Specifically in FSOC's designation of insurance companies, they have often presented the scenario of a run on the bank situation happening. Could you please explain how this scenario in fact is unlikely for insurance companies and how using it as a basis for designation is off base?

Mr. WHITE. I have to confess, of all the panelists here, I am probably the least expert on the specifics of financial regulation. But I will say that even a novice like me knows that an insurance company isn't the same as a Wall Street bank. Insurance companies are facing what is called maturity mismatch issues, where they aren't basing these things.

I think to the extent that the FSOC is lumping everything together in one regulatory approach, it is a mistake.

Mrs. WAGNER. For Professors Macey and Scott, with regard to the asset management industry, while FSOC has not entirely ruled out designating specific companies, it has said that they will try an activities-based approach. Do you believe that FSOC should also consider this approach for designating insurers, rather than simply relying on the size of the company?

Professor Scott or Macey, whomever?

Mr. MACEY. I think that this is the kind of regulatory initiative that increases rather than decreases systemic risk. The most basic concept in finance is the idea of safety through diversification.

And one way that diversification manifests itself from a systemic perspective is if you have a lot of firms in the economy and they are all doing different things, so that if somebody is doing something that is stupid and causes the firm to fail, that is not such a big problem, because there are other firms in this heterogeneous economy that are doing other things that are successful.

And if we take all firms and we move them under the aegis of a single risk regulator such as FSOC, and we regulate them, we lose the societal benefits of this heterogeneity and increase systemic risk.

Mrs. WAGNER. And let me, in my brief time that is left, ask, what is the rationale for using the activities-based approach in the asset management industry but not in the insurance sector?

Professor Scott?

Mr. SCOTT. I think we learned a lot from the asset management experience that demonstrated that whatever concerns you have in

the asset management industry are not going to be solved by designating two or three large firms as SIFIs, because we have different firms holding different assets, and if there is an asset class concern, it might not involve the people that we designated as SIFIs.

So we learned a lot. It seems to me we should go back and say, "What did we learn from that, that would apply to the insurance industry?"

Now I think there is one problem with insurance, Congresswoman. That is, unlike asset management where you have a Federal regulator of the asset managers, which is the SEC, in the case of insurance, we have no Federal regulator. And as you know, this committee in the past, even before the crisis, has considered the appropriateness of the Federal regulator on an optional or mandatory basis for insurance companies.

I think that the lack of such a regulator actually plays into the SIFI process because if there were such a regulator you could say, just the way we did with asset management, the SEC or the Federal regulator can handle this. In the case of insurance companies, it is the States, okay?

Mrs. WAGNER. Right, which is to say that—

Mr. SCOTT. So we have to have—

Mrs. WAGNER. —that deals ultimate jurisdiction—

Mr. SCOTT. —we have to have a lot of confidence in the ability of the States to do that. Maybe we should. But the issue is slightly different for insurance than asset management.

Mrs. WAGNER. I am way over my time.

Chairman DUFFY. You are—

Mrs. WAGNER. I thank the Chair for his indulgence.

And I thank you all.

Chairman DUFFY. The gentlelady's time has expired.

The Chair now recognizes the gentleman from Colorado, Mr. Tipton, for 5 minutes.

Mr. TIPTON. Thank you, Mr. Chairman.

And I would like to thank the panel for taking the time to be here today.

I am a small business guy from Colorado and I had a very simple business premise: If it is broken, fix it; if not, stop doing it.

And, Professor Macey, when I was listening to your comments, I found them very concerning in terms of the potential impacts on our economy. You had made the comment that the FSOC has an impossible task that they are performing poorly—I may be paraphrasing you just a little bit—and there is no consequence for a type two error, designating an institution as a SIFI when it is not.

Have we literally incentivized regulation and a broadening net of regulation in this country under Dodd-Frank?

Mr. MACEY. I think we have. I think that you can think about regulation pre-Dodd-Frank and post-Dodd-Frank in the following way: We used to think of the basic idea of risk regulation as the virtue of diversification; don't put all your eggs in one basket.

Dodd-Frank says the opposite. It says, "Let's put all of our eggs in one basket and watch the basket very carefully." And we have to have a lot of confidence and faith in those regulators.

For example, take what Professor Scott was saying about insurance regulation. I think the evidence is pretty clear that despite

what might be the lack of prestige of these State insurance regulators, the fact is the insurance industry in this country is extremely sound, with very strong balance sheets; a lack of mismatch between the term structure of assets and liabilities; is very well-collateralized; and is extremely responsible. Say securities borrowing, the entire business, I think, is a model.

And I think there is a concern that was suggested by Professor Scott that when FSOC looks at insurance companies and they say, "Of course they should be systemically important because they don't have a Federal regulator. So we will be their Federal regulator." Because once we designate them as systemically important, the Fed comes in.

I think that it is a basic choice, and I think Dodd-Frank makes a choice that I personally don't think is the right one.

Mr. TIPTON. And that lends itself back—you just made the comment that we have to be able to have confidence in the regulators to be able to make these decisions. And this gets back to the point of likelihood, the actual exposure that is really going to be there.

Professor Scott, would you like to comment on that?

Mr. SCOTT. I personally do not have confidence in the ability of FSOC to reach the right result with respect to these designations. I don't think doing this by committee vote, including people who don't know much about the industry that we are talking about in any given situation, is just not the way to run a railroad. If we were going to do this kind of thing, at least we should have experts. So that undermines confidence.

Now we have this bizarre situation where we don't know what the consequence is of designating them. So we designate them, and now the Fed is looking at, how are we going to regulate insurance companies that have been designated?

You would think logic would say, let's know what the consequence of the designation is before we designate them. But we don't know what it is. That undermines confidence.

It really comes back, Congressman, to the fact that we created this instrument, FSOC, to deal with our failure collectively to really reform the regulatory structure. And this is not the answer. And we are seeing now in spades why that is the case.

Mr. TIPTON. So you don't want the cobbler running the railroad, even though they are both in transportation. You have to be able to have some real common sense actually applied to the process.

When we are talking about getting Congress involved—and, Mr. White, you might want to be able to jump in on this, as well—I am incredibly passionate about Congress being able to have a role. The only reason FSOC exists—I wasn't here when Dodd-Frank was passed, but the only reason that they—Dodd-Frank and a lot of the entities, CFPB, we can go down the list, that they come out is because of an act of Congress.

Is it incredibly important that we get Congress involved once again into the rulemaking process? You had cited having clear perimeters and we will let the courts decide. Would it actually be appropriate to have the people who wrote the laws actually play a role in that rulemaking process?

Mr. WHITE. Absolutely. The Supreme Court said in a recent case, the Free Enterprise Fund case, that often it is in one President's

interest to give away his own powers, but that doesn't mean that should be allowed to happen. And the same could be said for Congress.

You asked a moment ago, "Are we just trusting the regulators?" I guess I would use the line, "trust but verify," and that requires three things: Congress setting clear standards; regulatory procedures in the sunshine; and meaningful judicial review.

Mr. TIPTON. Thank you.

Mr. Chairman, my time has expired. Thank you.

Chairman DUFFY. The gentleman yields back.

The Chair now recognizes the gentleman from Maine, Mr. Poliquin, for 5 minutes.

Mr. POLIQUIN. Thank you, Mr. Chairman. I appreciate it very much.

And thank you, gentlemen, for all being here today.

I am sure you folks are all familiar with a study done a couple of years ago by the former Director of the nonpartisan CBO, Mr. Holtz-Eakin. If you aren't familiar with the study, effectively it says if you look at the long-term rate of return that asset managers, pension fund managers, and mutual funds, and so forth and so on, can generate for their clients, there is about a 25 percent reduction in the long-term rate of return if these non-bank financial institutions, i.e. asset managers, are designated as SIFIs.

The reason for that, of course, is that the costs go up because the regulations, the product offerings shrink, and rates of return go down.

Now, at a time where many Americans are concerned about running out of money before they run out of time, I would hope that you folks would agree that we want to make sure that we help small investors throughout our country prepare for retirement, help to save for college study, and so forth and so on.

No, morphing into specifically some of the companies I have been talking about—or talking to over these last few months, many of them have come to me with business plans that are dramatically altered as compared to a few years ago. They are shedding product lines. They are consolidating. They are getting out of businesses that they normally would be in because of the regulatory burden of Dodd-Frank—in particular, the threat of being designated as a SIFI.

Now, when you are an asset manager, we all know. And if Mr. Tipton and I run two different mutual funds and our performance is different, well the clients from one firm are going to go to the client of another where the better performance is. In this case, of course, my performance is better than Mr. Tipton's.

Now, in which case these assets are not held on Mr. Tipton's balance sheet as his firm or mine. The assets are held at a custodial bank in another State, another country, or down the road. And so there is no systemic risk to the economy if one of these companies—they are not too-big-to-fail. It doesn't make any sense.

There is no systemic risk posed by asset managers. So to so designate them as SIFIs and threaten the long-term rate of return of small investors doesn't make any sense to me.

So my question to you is the following: Don't you think it makes sense if you are running an asset management firm, you should

have clear, written criteria so you know if you are in these certain business lines? Then, the chances of you being designated a SIFI and having to go through all this is clear.

And then once you are designated a SIFI, don't you think it makes sense that you should know what the off-ramp should be so I can make a decision, if I am in this business now or going to be in this business or offering this product line, that I know how to get out of the SIFI designation if I do certain things?

Mr. Macey, why don't you take a shot at that, if you don't mind, sir?

Mr. MACEY. You raise a number of interesting points, and I want to focus on two.

The first is the lack of any process, procedure, or guidelines, guidance of any kind about how an entity can stop being a SIFI once it receives that designation.

We are seeing an interesting natural experiment, of course, with GE Capital, which has been designated as a SIFI, is consistent with your observations and the Congressional Budget Office's intuition. They looked at the cost of that and said, "We don't want to be in the finance business any more in a significant way." So that is a very significant concern.

Generally speaking, I think if somebody came down to Earth from Mars and was handed Dodd-Frank, along with a number of other Federal statutes regulating the financial industry, and was asked, "Can you build a plausible case that these are intended to hurt small business?" the answer would have to be "yes."

Maybe they weren't intended to do that, but it certainly is the consequence and if you—so reasoning backwards from the consequence, one has to make that inference, in my view.

Mr. POLIQUIN. Mr. Scott, we are a country of laws. And whether you are a defendant individually or you are a company lawfully conducting business in the financial services space in this country, don't you think it is reasonable and appropriate to make sure your government provides you with due process, to make sure you know the path going forward, what is best for you, your stockholders, and your customers?

Mr. SCOTT. Certainly, Congressman. That is a hallmark of our country.

Mr. POLIQUIN. And do you think that this whole SIFI designation process offers that due process?

Mr. SCOTT. I am not a constitutional expert. I will defer to my colleagues. But in terms of a common understanding of that term, I don't think it offers due process.

But just to stress the point, this is not just an issue for that company. This designation affects the entire financial system. It affects competitors, and it affects customers.

So, yes, we worry about the due process to the company, but I am just as concerned with the economic impact on everybody else outside this company of that designation.

Mr. POLIQUIN. Thank you, gentlemen, for being here. I appreciate it very much.

Thank you, Mr. Chairman. I yield back my time.

Chairman DUFFY. The gentleman's time has expired.

The Chair now recognizes the gentlelady from Ohio, Mrs. Beatty, for 5 minutes.

Mrs. BEATTY. Thank you, Mr. Chairman and Mr. Ranking Member. I am having a little voice problem this morning.

And thank you, to the witnesses.

I have just a few brief comments, and then, Mr. Chairman, if it is okay, I would like to relinquish the balance of my time to Congressman Green.

First, let me just say thank you for being here this morning. I have a lot of insurance companies located in my 3rd congressional district. If one of my local or State domicile insurers were to be designated, can you explain to me what would be the process for determining the issues of regulatory jurisdiction between the Ohio Department of Insurance and the Financial Stability Oversight Council, if any?

Mr. MACEY. I guess in a nutshell, I would say it is sort of like being at a dance where you can dance with more than one person at the same time. So if there is an insurance company in your district and the FSOC designates that insurance company as a SIFI, it will continue to be regulated by your State insurance department and commissioner.

In addition to that, Dodd-Frank provides that after the designation as a SIFI, the Federal Reserve has the authority to promulgate sort of customized bespoke regulation for that insurance company. And at the time of the designation, nobody has—it is going to be a mystery as to what the consequences are.

So there will be regulation. And this is what we saw with GE Capital; this is what we saw with MetLife. We have seen it in every instance of a non-bank SIFI designation.

And it will be—one of—if they think that your—the management of your—the insurance company in your district is not sharp or doesn't have experience, it will be more heavily regulated. If they think that the products, certain insurance lines of business, are riskier than others, it will be more heavily regulated.

If there is a difference between what the Fed thinks should be done and what the State insurance office in your State thinks should be done, the regulators will tell them they have to comply with both sets of regulation, notwithstanding the fact that they may be in conflict.

It is difficult, which is why I prefer academia to the real world. But it is a tough position that your constituent would be in, your insurance company constituent.

Mrs. BEATTY. Thank you.

Mr. Chairman, I would like to relinquish the balance of my time to Congressman Green.

Mr. GREEN. Thank you. And I pray that the gentlelady will recover quickly because her strong voice is very much needed in the Congress.

Mr. Macey, dear sir, we were talking earlier—in fact, you and one of the members—about withholding evidence. And you had some concern about this withholding of evidence in the MetLife case. My assumption is that you are concerned about due process being afforded. Is that a fair statement?

Sir, first we will have to—

Mr. MACEY. I was just saying I was—

Mr. GREEN. I am going to have to do this—I have a little bit of time—

Mr. MACEY. Okay.

Mr. GREEN. Let me just ask you.

Mr. MACEY. Okay.

Mr. GREEN. Are you concerned about due process? Is that your rationale?

Mr. MACEY. A little bit. Not overwhelmingly. I would be more concerned if somebody—an individual citizen—I am concerned with their due process rights. I don't really, frankly, stay up at night—

Mr. GREEN. You are not concerned about due process for—

Mr. MACEY. —worrying about—

Mr. GREEN. You are not concerned about due process for a corporation?

Mr. MACEY. It is not my primary concern.

Mr. GREEN. Okay.

Mr. MACEY. I am a little bit worried about it. I would like them to have due process. But my view is much more the societal consequences of—

Mr. GREEN. And when we were talking about the withholding of this evidence, we were talking specifically—you and a member were talking about in the MetLife case, because that is the case in question, is it not?

Mr. MACEY. I thought we were just talking generally about—

Mr. GREEN. No, you were talking about MetLife, because—

Mr. MACEY. Okay. I am happy to talk about MetLife.

Mr. GREEN. Your testimony, sir, that—your written testimony is replete with comments about MetLife.

Mr. MACEY. Yes.

Mr. GREEN. You haven't said much about it in your oral testimony, and I suspect that when I came in and threw the marker down, it created some problems for a lot of people. But your written testimony is replete—

Mr. MACEY. That is true.

Mr. GREEN. —as is yours, Mr. Scott, with MetLife.

And of course, Mr. Hockett, yours is too.

And, Mr. White, let me commend you. You spoke of it when you gave your verbal testimony.

So you are all talking about MetLife, and let's just be honest today: It is MetLife that we are talking about. If MetLife were not in a Federal district court here in D.C., we wouldn't be having this hearing. It is all about MetLife, a \$900 billion company.

Now, I am going to insist that I place some things in the record. The first will be the letter that I referenced earlier, wherein the ranking member and I made a request that persons who are not major corporations have an opportunity to have their cases litigated before the Congress—in a fair way, of course. Any objections—

Chairman DUFFY. Without objection, it is so ordered.

Mr. GREEN. Thank you very much. We will place that in the record.

I would also, given that this is about MetLife, like to place in the record a brief from many of the law professors who are in support

of the position of FSOC as it relates to the litigation against MetLife.

Chairman DUFFY. Without objection, it is so ordered.

Mr. GREEN. Thank you, Mr. Chairman.

And now, let's just talk about these companies. MetLife, as you know, deals in derivatives, about \$200 billion worth, according to Bloomberg. With these \$200 billion worth of derivatives, I find that I have to be concerned about them.

MetLife, while it is not AIG, we do know that AIG created a problem because of its derivatives. And that was so stated, as a matter of fact, by the Office of Thrift Supervision. They acknowledged it.

So MetLife has \$200 billion worth of derivatives, and it is a \$900 billion company. So are you saying that under no circumstances, Mr. Macey, a \$900 billion company with \$200 billion in derivatives—under no circumstances should it ever be a SIFI?

Mr. MACEY. No.

Mr. GREEN. Thank you.

Mr. Scott, are you saying that a \$900 billion company, with \$200 billion in derivatives—and if you want to know about its interconnectedness I can share that with you, because we have MetLife's own comments about how connected it is in the world—are you saying that it should not be, under any circumstances, a SIFI?

Mr. SCOTT. You will have to give me the opportunity to put this in context.

Mr. GREEN. Okay. Let's do this then; we will pass.

Let's go to Mr. Hockett.

Mr. Hockett, sir, is it easier to place a bank holding company—a chartered bank—is it easier for a chartered bank to become a chartered bank through the OCC than for a major corporation that is a non-SIFI to become a SIFI?

Mr. HOCKETT. That is actually a great example to bring up. The processes are actually quite similar.

What is really interesting is that the OCC has a great deal of discretion in deciding whether to confer a charter on a bank. There is no formal sort of adjudication required, only informal, as in the case of SIFIs.

A six-factor balancing test is applied. There is no sort of algorithmic tradeoff between different factors. They are not weighted. Indeed, the law is actually replete with multi-factor balancing tests that don't have sort of weighted factors.

So actually, there are very strong, very close similarities between those two decision-making processes.

If I could add in a quick note on transparency matters, it really makes a difference that this is an informal sort of adjudication. The transparency requirements in cases like that by law are less than they are in actual formal adjudications.

The other thing that is worth noting is that one reason that you have less transparency in an informal process is there is a—an interest group that we are completely leaving out of account here so far, and that is the counterparties, right, of the prospective SIFI. That is to say, the institution that is being evaluated with a view

to whether it is a SIFI is being evaluated partly by reference to its counterparties.

Mr. GREEN. I have to reclaim my time. The—

Mr. HOCKETT. That is confidential stuff.

Mr. GREEN. I will have to reclaim my time and yield because of the essence of—

Chairman DUFFY. The gentleman's time completely expired 4 minutes ago—rather, the gentlelady's time.

The Chair now recognizes the gentleman from Arkansas, Mr. Hill, for 5 minutes.

Mr. HILL. Thank you, Mr. Chairman. Thank you for hosting this hearing today on FSOC.

I look at this whole FSOC process and the FSB world of looking at the idea of designating SIFIs, and I always try to follow Charlie Munger's long advice about life, which is to invert the question and look at it from the reverse.

And so the first thing that always strikes me is after Dodd-Frank and after we have an FSOC established, we ought to ask, is there significant weakness in how, for example, insurance companies are overseen today, and then more specifically, life versus property and casualty? Or should we ask the question, is there something dramatically wrong with the way asset management firms are regulated today, instead of taking it as I think we have, which is kind of charging forward with the presumption that they probably are ultimately SIFIs and then justifying that outcome.

So I really do approach it from the inverse. And part of that is based on my experience. I was at Treasury from 1989 to 1991, and in that time the insurance industry had a very difficult time—the life industry particularly—due to GIT contracts; and the famous failure of Executive Life in California; and the state of the real estate market in a post-market crash, post-Tax Reform Act of 1986.

But the Treasury studied the existing State system, the guaranty system, the focus, and they found that it was amazingly resilient at that time. And so, I entered this debate with the presumption that American life insurance regulation is quite resilient, quite protective of consumers, and quite prudential in its oversight of the companies.

It concerns me when FSOC has an expert, Roy Woodall, who dissents in FSOC's decision and he is not listened to.

So a question I have is, maybe for Professor Macey to start out, the reasoning behind trying to even designate insurance companies as SIFIs before the Fed has even established what the rules of the road are just strikes me as premature and kind of nuts, from a Charlie Munger inversion question point of view or from a linear point of view, that we are going to make the presumption that they are.

Could you just comment on that for me?

Mr. MACEY. I really appreciate that question for many reasons, not the least of which is that Charlie Munger is a hero of mine and he is a very practical, commonsense, smart guy.

I think it is a concern, and the reason this is a concern for me, and the reason that MetLife is a concern for me, is I don't think the world will come to an end if MetLife maintains its designation

as a SIFI. I think the problem you identify is the vagueness in the standard and the lack of any connection to an actual problem.

And this type-one, type-two error issue raises the following specter, which is we are sitting here right now talking about MetLife. I could easily imagine, based on plausible scenarios I have seen in other areas of economic regulation, that we would be in here 5 years from now, or maybe a year-and-a-half from now if there is another financial crisis, talking about firms that are not in the hundreds-of-billion-dollar category, but in the hundreds-of-million-dollar category, that you could—that every firm is—in the insurance industry is interconnected.

So it would be plausible, under the vague standards we have that caused the designation of MetLife, to designate hundreds of insurance companies as SIFIs.

Is it going to happen today? No. But that is why I think this is about more than MetLife and why I think your question is very germane.

Mr. HILL. Yes. It concerns me because when you look over at the banking side. I feel like the left hand doesn't know what the right hand is doing. If you look at the capital surcharge that has been proposed for G-SIFIs, the Fed has a set of metrics that measure liabilities, interconnectedness, dependency, and maybe short-term funding flows, and a whole variety of things that one can pull effectively from public information, either 10-Ks or Y-9s.

But we don't even attempt to do something similar for the non-bank holding company entities before we start down this road. So it is misdirected, I think, that we jump out and designate people before we have even decided what the rules are.

I thank you, and I look forward to the next round of questions. Thanks, Mr. Chairman.

Chairman DUFFY. The gentleman yields back.

Votes have been called, but we have two more Members here, and I think we can get through them before we walk off to vote.

The Chair now recognizes the ranking member of the subcommittee, the gentleman from Texas, Mr. Green, for 5 minutes.

Mr. GREEN. Thank you, Mr. Chairman.

Let's go back to you, Mr. Hockett. You were giving us some intelligence about the OCC and its methodology and comparing that to a SIFI designation by FSOC. Could you please continue, or would you?

Mr. HOCKETT. Yes, sure. Thanks for the question.

So again, throughout the regulatory state, you could say, and throughout our body of law there are lots of multi-factor balancing tests that don't have weighted factors. I suspect that is partly in recognition of the fact that many decisions that have to be made are much too complex to be captured by an algorithm, that in other words, legislators, regulators, and judges probably won't ever be able to be replaced by machines.

And so, you actually have lots of chartering decisions that often-times will be challenges, typically either by a would-be bank that is denied a charter, or by an incumbent bank that objects to a charter having been granted to an institution that will end up being in competition with that institution, and they routinely raise the same sorts of objections to the bank chartering authority, whether

it be the OCC at the Federal level or whether it be a State banking commissioner who makes the chartering decision at the State level.

Often, the arguments that they will make are very much like the arguments that MetLife has made against the FSOC in this particular instance.

Mr. GREEN. Thank you.

Mr. Chairman, I would also like to place in the record a document styled, "The Basis for the Financial Stability Oversight Council's Final Determination Regarding MetLife, Inc.," and I shall read from this document on page 29.

It reads, and this relates to how interconnected MetLife is, "By design, the winding-down of a failed insurer's estate may take several years to accomplish while policyholders and contract holder liabilities are paid off as they come due and are transferred to solvent issuers.

"MetLife is a highly complex and interconnected financial services organization that operates in approximately 50 countries and provides services to approximately 100 customers globally. The complexity of MetLife's operations and intercompany relations, including intra-group dependences for derivatives management, investment management, risk management, cross-border operations, and critical services, creates complexities that could pose obstacles to a rapid and orderly resolution."

And then it goes on to indicate that, "there is no precedent for the resolution of an insurance organization the size, scope, and complexity of MetLife." Now, this comment is being made after AIG. And as we found out, AIG was a part of the glue that was holding the economic order together. So—

Chairman DUFFY. Mr. Green, without objection, the document will be included in the record.

Mr. GREEN. Thank you, Mr. Chairman.

With AIG, we found that we eventually had to bail them out—\$182.3 billion, in fact. So the question is, given the complexity of MetLife, why would FSOC not seek to ascertain whether or not it should be designated as a SIFI? This is a huge, mega corporation.

Mr. Hockett, would you kindly give some commentary?

Mr. HOCKETT. Yes. Thanks so much for the question.

Again, this goes back to something I mentioned in my opening statement, and that is that, again, there was a time when insurance companies were sort of categorically distinct from the other kinds of financial institution. And that is still largely true of many smaller insurance companies.

But the fact is there are some very large insurance companies that are not traditional insurance companies and that depart in various ways from the traditional insurance company model. That is why I actually mentioned MetLife in my opening testimony just briefly, but I mentioned it in order to note, first, that it was a bank holding company as recently as 2012, that it failed a stress test at that time, and while it has since relinquished its bank holding company status, it nevertheless remains a very large, far-flung, highly complex financial institution.

And indeed, the FSOC and many experts, including terrific business professors at the University of Chicago, at Stanford University, Yale, and elsewhere, and law professors, have noted that its—

the term structure of its balance sheet—that is to say the term structure of its liabilities on the one hand and its assets on the other—are not those of the traditional insurance company and, indeed, there can be significant maturity mismatch in as much as some of the policies that MetLife in particular offers can be liquidated quickly.

But again, I don't want to get too hung up on just MetLife. I think as a general matter, this is an important phenomenon.

Mr. GREEN. I will have to yield back now.

Chairman DUFFY. The gentleman yields back.

The Chair now recognizes the gentleman from Illinois, Mr. Hultgren, for 5 minutes.

Mr. HULTGREN. Thank you, Mr. Chairman.

Mr. White, first question: In your written testimony, you note that SIFI designations can in some cases provide a competitive advantage despite the heightened regulatory requirements because of the lowered cost of capital an institution might receive due to the perception of being too-big-to-fail. What reforms would you recommend to remedy the market distortion that could be caused by FSOC's unchecked authority?

Mr. WHITE. First of all, I am very glad you asked that, because I wanted to point out earlier that while MetLife is one case that is litigating these issues, a small West, Texas community bank that I represented in a lawsuit challenging the SIFI designation process, challenging it as a subsidy, that is where a lot of these issues were first raised.

I think in terms of fixing the problem, first of all, I think clear standards are important. I think it is inevitable that this designation is going to operate as a subsidy, and so I think the regulators' discretion needs to be cabined so that they can't just hand it out willy-nilly. I think it is important that there are clear standards by Congress as to which companies these designations can be placed upon.

Mr. HULTGREN. Thank you.

Professor Scott, in your testimony you note that the FSOC should involve potential designees in its process at the very start and should provide the designees with complete transparency into the basis for any potential designation. Two-part question: First, based upon FSOC's actions to date, do you think they are inclined to provide this due process? And second, should they be required to do so and what can Congress do?

Mr. SCOTT. Congressman, I don't think they have been provided that due process. They have not been able to see the record on which FSOC made this determination, and I think they should be provided that. As I said in my testimony, if FSOC doesn't do so on its own, I think the Congress should require that.

Mr. HULTGREN. Thank you.

Professor Macey, if I can address this to you, as you know, in April 2012 FSOC issued a rule claiming the authority to require supervision and regulation of certain non-bank financial companies but determined a cost-benefit analysis was not required under the Regulatory Flexibility Act.

Two-part question: First, what do you think would have been the outcome of a thorough cost-benefit analysis? And second, what

costs is the FSOC imposing on life insurance policyholders and possibly investors through its SIFI designation, and does this threat or risk of a designation impose any costs?

Mr. MACEY. The designation certainly imposes significant costs. Really underlying your question, I believe, is the question of, does a SIFI designation convey too-big-to-fail status? And the answer to that is inevitably, definitively, "yes."

One of the things that we know as an institutional fact is that once an organization is designated as a SIFI, particularly a non-bank SIFI, there are regulators who are assigned to regulate that entity, and their entire career depends on that entity remaining in business and in operation.

So inevitably, there will be both costs and benefits to being designated as a SIFI: massive regulatory burden; and higher capital requirements. And for different firms, those costs will or will not be outweighed by the benefits, which come in the form of a credit enhancement for this implicit too-big-to-fail status.

So it is generally just sort of a deadweight efficiency loss.

It would be important to do a cost-benefit analysis. People talk about this, though, as though it is kind of a binary choice, which is to say, as you point out, if I don't have to do a cost-benefit analysis, maybe you should have to do one.

A middle ground would be to say, okay, unlike, say, certain SEC rules, the cost-benefit analysis does not have to generate a result such that the benefits are greater than the costs. That doesn't mean you can't do the analysis.

One could do the analysis just for informational purposes to kind of get a handle on what is at stake here. And at a minimum, it seems to me strange that we don't even make that attempt.

Thank you.

Mr. HULTGREN. Mr. Chairman, I have about 20 seconds left. If the chairman wants, I would yield back to him. Otherwise, I yield back the balance of my time.

Chairman DUFFY. The gentleman yields back.

In about an hour-and-a-half, we have packed a pretty good punch. I want to thank the panel for their testimony.

As I have indicated, votes have been called. There is about zero left on the clock, so we are going to have to go do our constitutional duty and cast our votes right now.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

Again, thank you for your testimony.

And without objection, this hearing is now adjourned.

[Whereupon, at 10:52 a.m., the hearing was adjourned.]

A P P E N D I X

November 19, 2015

Written Testimony of Robert Hockett

**Edward Cornell Professor of Law, Cornell University
Senior Consultant, Westwood Capital Group
Fellow, The Century Foundation**

**Before the Subcommittee on Oversight and Investigations,
Committee on Financial Services
United States House of Representatives**

(November 19, 2015)

**“OVERSIGHT OF THE FINANCIAL STABILITY OVERSIGHT COUNCIL: DUE PROCESS AND
TRANSPARENCY IN NON-BANK SIFI DESIGNATIONS”**

I. SCOPE OF TESTIMONY AND QUALIFICATIONS

Thank you for inviting me to speak with you here today. My understanding is that you would like my testimony to discuss two matters of concern to you and to all Americans. Those are the constitutional due process and public transparency of Financial Stability Oversight Council (FSOC or the Council) designations of non-bank financial companies as Systemically Important Financial Institutions (SIFIs).

My understanding is also that you have invited my testimony in light of my academic and other occupational credentials. Those are, in brief, as follows. I hold the Edward Cornell Endowed Chair in Law at Cornell University,¹ where I have taught since 2004. (My office was previously Jon Macey’s.) I am also a Member of the Executive Committee, and former Chair, of the Association of American Law Schools’ Section on Financial Institutions and Consumer Financial Services;² a Member of the New York City Bar Association’s Committee on Banking Law;³ a Fellow of The Century Foundation,⁴ a long-established public policy institute with which I have been associated for nearly four years; and a former Fellow and ongoing associate of

¹ Webpage available at http://www.lawschool.cornell.edu/faculty/bio_robert_hockett.cfm.

² Webpage available at http://memberaccess.aals.org/eWeb/dynamicpage.aspx?webcode=ChpDetail&chp_cst_key=a99dc504-4ef4-43e4-bd35-7f0eb1083b7b.

³ Webpage available at <http://www.nycbar.org/banking-law>.

⁴ Webpage available at <http://tcf.org/experts/detail/robert-c.-hockett>.

Americans for Financial Reform (AFR), a finance-regulatory think tank. Finally, I am a Senior Consultant with Westwood Capital Group, an investment bank in New York.⁵

My principal fields of research, writing, teaching, and practical expertise lie in the realms of enterprise-organizational, monetary, and finance-regulatory law. The functions of macroprudential finance-regulatory councils like the FSOC and central banks like the Federal Reserve (the Fed or FRB) figure with particular importance in much of what I do in these connections, from academic research and writing to conference-organizing and -participating. I am also the author of what soon will be one of the only two or three American law school coursebooks that treat financial regulation in a comprehensive and integrated fashion,⁶ while most of my other academic writing since 2008 has been on (a) the causes of our recent financial difficulties and (b) plausible cures to the ills that have occasioned them.⁷

Prior to entering the legal academy and then again during my sabbatical year of 2012-13, I worked at the International Monetary Fund (IMF, also “the Fund”). As you know, the Fund is one of a small number of intergovernmental organizations through which governments with jurisdiction over the world’s most financially developed economies act in concert to oversee the now globally integrated international monetary and financial systems.⁸ During my first stint there in 1999-2000, my work was on corporate- and finance-regulatory reform proposals under consideration in the wake of the Asian, Russian, and then-gathering Argentine financial difficulties of the era.⁹ During my second stint in 2012-13, which I arranged during my sabbatical in order to help “keep my feet wet,” my work was primarily on how best to implement, harmoniously and through law, new proactively crisis-preventive, “macroprudential”

⁵ Webpage available at <http://www.westwoodcapital.com/ourpeople/robert-hockett/>.

⁶ ROBERT HOCKETT, CASES AND MATERIALS ON FINANCE AND ITS REGULATION (West, 2016) (forthcoming).

⁷ See, e.g., Robert Hockett, *A Fixer-Upper for Finance*, 87 WASH. U. L. REV. 1213 (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1367278; Robert Hockett, *The Macroprudential Turn: From Institutional “Safety and Soundness” to “Systemic Stability” in Financial Supervision*, 9 VA. L. & BUS. REV. 1 (2014) (forthcoming), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2206189.

⁸ See Robert Hockett, *Bretton Woods I.0: A Constructive Retrieval*, 16 N.Y.U. J. LEGIS. & PUB. POL’Y 1 (2013), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1805962.

⁹ See, e.g., Robert Hockett and Barry A.K. Rider, *The Regulation of Insider Dealing*, IMF White Paper, March 2000 (available on request).

approaches to financial regulation that had been adopted post-2008 in the U.S., the U.K., the E.U., and other jurisdictions.¹⁰

I have also worked, again to “keep my feet wet,” at the Federal Reserve Bank of New York (FRBNY) during my academic career. From the early summer of 2011 to the early autumn of 2012, I worked there in a continuous consultative capacity, both in the Legal Department and with economist colleagues in the Research and Statistics Group. The projects on which I worked at FRBNY were numerous and fell under a variety of categorical headings. They included, *inter alia*, helping to identify existing regulatory provisions through which to implement new macroprudential finance-regulatory tools, helping to draft formal Comment Letters in connection with proposed rulemakings by other finance-regulatory agencies, and legal analyses tracing and assessing the likely domestic consequences of possible currency regime changes abroad.

My work at Westwood Capital also is in some cases concerned with or informed by macroeconomic and associated macroprudential finance-regulatory considerations, though it is in other cases more concerned with helping to finance specific transactions that we think likely to yield broader market and other social benefits. It is accordingly another way of “keeping the feet wet,” even if not in every case quite as policy-focused as my academic and other practical work. I believe, then, that I am able to speak from both a scholarly and a practical angle in what I will address here today. But I should emphasize before proceeding that what I shall say I say solely in my individual capacity and not on behalf of any institution with which I am or have been affiliated.

¹⁰ See, e.g., Robert Hockett et al., *Implementing Macroprudential Finance-Oversight Policy: Legal Considerations*, Draft IMF White Paper, February 2013, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2340316; also Robert Hockett et al., *Implementing Macroprudential Policy – Selected Legal Issues*, IMF Board Paper, June 17, 2013, available at <http://www.imf.org/external/np/pp/eng/2013/061713.pdf>; and Robert Hockett, *Practical Guidance on Macroprudential Finance-Regulatory Reform*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION, November 22, 2013, available at <http://blogs.law.harvard.edu/corpgov/2013/11/22/practical-guidance-on-macroprudential-finance-regulatory-reform/>.

**II. BACKGROUND TO TODAY’S HEARING: THE NEED TO INTEGRATE CONSTITUTIONAL
VALUES WITH EFFICIENT GOVERNANCE IN GENERAL, AND WITH EFFICIENT FINANCIAL
GOVERNANCE IN PARTICULAR**

The concerns to be discussed here today are in a certain sense “hardy perennials.” They implicate two longstanding and related dilemmas we face in governing ourselves as a nation. The first dilemma is how to reconcile our fundamental constitutional separation of powers and due process values with efficient governing of our nation and its markets in general. The second dilemma is how to reconcile sector-specific expertise with the need for cross-sectoral awareness and understanding of our financial markets in particular. Both of these dilemmas have always been with us, and always will be. Today’s discussion is only the latest in a never-ending conversation that will continue for as long as we value governance that is both constitutionally bounded yet efficient on the one hand, and both “deep” and “wide” in its understanding of what we aim to regulate on the other hand.

A. First Dilemma: Efficient Governance and Constitutional Constraints

With respect to the first dilemma, the nation reached a stable equilibrium, where the balancing of constitutional values with efficient government is concerned, some seventy to eighty years ago. You all know the story. On the one hand our Founders, learning from Montesquieu, wisely decided that republican freedom was best safeguarded when the legislative, executive, and adjudicative functions of national government were vested in distinct “branches” thereof. On the other hand our subsequent forebears, less than one hundred years later, found that governing a rapidly growing, dynamically changing, and increasingly complex economy could not be efficiently done on a day-to-day basis by Congressionally legislating every executive action.

For one thing, in highly technical areas – like, e.g., nuclear energy or modern “rocket science” finance – a great deal of highly specialized expertise was necessary. For another thing, Congress was simply too busy and highly placed a body to meet upon and debate, every day, each discrete action a regulator might take in regulating a field – like, again, nuclear energy or modern “rocket science finance” – in which disaster-avoidance was literally a daily imperative.

The first response to this dilemma, late in the 19th and early in the 20th centuries, was to opt in favor of streamlined government efficiency, on the theory that the Congress which established and empowered specialized regulatory agencies was, after all, itself democratically elected. Congress thus empowered specialized executive agencies to regulate specific industries in relation to which highly developed expertise and rapid-response regulatory authority was necessary.¹¹ Sometimes it carefully laid out the boundaries of such agencies' mandates, however, while other times it delegated rather more loosely.¹² When it did the latter, the link between democratically elected legislators and unelected regulators could of course loosen. For the looser the mandate, the easier it was for any rule articulated by an agency as the basis for regulatory action to pass muster as having been "okayed" by Congress. What, then, was the optimal degree of legislative bounding of executive agency action?

The definitive reply to that question began as a mixed jurisprudence under the heading of a court-developed "non-delegation" doctrine.¹³ Pursuant to some early cases decided under this doctrine, Congress was said to be categorically prohibited from delegating legislation-reminiscent rulemaking functions to executive agencies.¹⁴ During its heydays, the nondelegation doctrine accordingly saw courts opting routinely to sacrifice government efficiency wholesale at the altar of a particularly cramped understanding of constitutional purity.¹⁵ That made the exercise of public authority over a huge, complex, and dynamically changing economy all but impossible. Courts were treating the Constitution, some accordingly said, as a "suicide pact."

By 1928, however, courts had begun frequently to recognize that we could have our cake and eat it too where efficient governance and constitutional fidelity were concerned.¹⁶ As long as our democratically elected Congress provided an "intelligible principle" on the basis of which regulatory agencies could ascertain the boundaries of their mandates, it was held, and as long as both Congress and the courts maintained ultimate oversight authority over the conduct of

¹¹ An accessible history here is THOMAS K. MCCRAW, *PROPHETS OF REGULATION: CHARLES FRANCIS ADAMS; LOUIS D. BRANDEIS; JAMES M. LANDIS; ALFRED E. KAHN* (1986).

¹² *Id.*

¹³ See, e.g., Andrew J. Ziaja, *Hot Oil and Hot Air: The Development of the Nondelegation Doctrine through the New Deal, a History 1813-1944*, 35 HASTINGS CONST. L.Q. 921 (2008).

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ See, e.g., *J. W. Hampton, Jr. & Co. v. United States* (1928). Earlier antecedents include *Field v. Clark*, 143 U.S. 649 (1892); and *Wayman v. Southard* (1825).

regulatory activity, efficient regulatory activity would be consistent with our constitutional values. That is effectively the settlement with which we have lived ever since. Its definitive codification is found not only in post-1928 jurisprudence, but also in the Administrative Procedure Act of 1946 (APA),¹⁷ itself upheld and interpreted over time by our courts.

The APA regime effectively recognizes the need of efficient governance on the one hand, while safeguarding basic constitutional values in the carrying out of that governance on the other hand. Hence it recognizes, for example, that when Congress prohibits in broad language the “use or employ[ment], in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, ... any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors,”¹⁸ and establishes a specialized agency – the Securities & Exchange Commission (SEC) – to determine over time what new schemes and scams developed by sharp operators should *count* as devices or contrivances of this kind, this need not offend constitutional values. At the same time, it establishes procedures – required public notice and comment periods, responsive alterations of proposed regulatory text, reviewability in federal courts, etc. – aimed at ensuring public input into, and the legislative and constitutional propriety of, all regulatory output.

By the same token, the APA regime recognizes that Congress might see fit, again in the name of efficient deployment of government resources, to afford preliminary adjudications of disputes between regulators and regulated parties before administrative law judges (ALJs), in the event resolution might be had before taking up the time of the courts and incurring the heavy costs of lawyered up litigation. Again at the same time, however, the Act and the courts recognize and enforce the rights of aggrieved parties to resort to the courts when they remain unsatisfied by the remedies had within agency adjudications themselves. This is how we reconcile efficient governance with unimpaired access to the judicial branch of our government – our Article III courts.

One could go on, but the central point is now made. For nearly a century we have operated with a workable settlement that reconciles the imperatives of modern and efficient

¹⁷ Codified at 5 USC ch. 5, aubch. 1.

¹⁸ See 15 USC 78j, codifying Section 10(b) of the Securities Exchange Act of 1934.

governance of a vast, dauntingly complex, and ever-growing economy with hundreds of distinct sectors on the one hand, and those of our founding 18th-century political document on the other hand. The Financial Stability Oversight Council (FSOC), more on which below, must be examined within the context of that delicate but longstanding balance on which we settled as a nation quite long ago. Its basic functions and operations are in no way unfamiliar within that habitat. Hence we shall have to distinguish between claims that the FSOC can be improved on the one hand, and claims to the effect that it is somehow constitutionally or administratively extraordinary or anomalous on the other hand.

B. Second Dilemma: Sector-Specific Expertise and Cross-Sectoral Awareness

Our nation's answer to the first dilemma – that of reconciling efficient governance with basic constitutional constraints – I noted to be of long standing. Our answer to the second – that of reconciling sectoral expertise with cross-sectoral understanding – is of more recent vintage, at least where the regulation of finance is concerned. It is the FSOC, established just over five years ago.

As many of you know, the U.S. is more or less unique among comparably developed jurisdictions in the number of distinct financial regulators that have overseen its complex and sprawling financial system for decades. At least three distinct regulatory agencies (the Fed, FDIC, and OCC¹⁹) oversee federally-chartered or -insured commercial banks, for example, while state regulators supervise state-chartered commercial banks alongside those banks' federal insurer, the FDIC. Other regulators (primarily the NCUA and, until 2011, the OTS²⁰) have, along with the Fed in the case of some holding companies,²¹ helped supervise some of the nation's noncommercial ("thrift" and "credit union") banking institutions, while still others

¹⁹ The FDIC is the Federal Deposit Insurance Corporation, which insures all federally chartered and nearly all state chartered depository institutions. The OCC is the Office of the Comptroller of the Currency, housed in the Department of Treasury, which charters national banks and administers the lending-limit and other portfolio-shaping regimes to which those banks are subject, among other things. Its counterpart in the case of state-chartered banks is typically called the state "banking commissioner."

²⁰ The NCUA is the National Credit Union Administration, charged with regulating that form of noncommercial (i.e., non-shareholder-owned) depository institution known as the "credit union." The OTS was the Office of Thrift Supervision, which used to regulate other forms of noncommercial ("thrift") institutions, and whose former duties since 2011 have been parceled out among the other depository institution regulators.

²¹ See below for more on the Fed's supervisory role vis-à-vis holding companies that own depository institutions of various stripes – commercial banks, thrifts, etc.

(FHA and FHFA²²) oversee the nation's system of home mortgage finance. Meanwhile, another regulator (the SEC²³) has primary responsibility for overseeing the nation's securities markets and the firms, including broker-dealers ("investment banks") and investment companies ("mutual" and "closed-end" funds) that operate therein. And yet another regulator (the CFTC²⁴) oversees the derivatives markets. Finally, under the McCarran-Ferguson Act of 1945, state insurance commissioners take primary responsibility for regulating the nation's (since 2010, non-SIFI²⁵) insurance firms, including the actions they take in their capacities as financial intermediaries.

The fragmented or "siloed" character of our financial regulators, which was quite stark before 2010 and remains pronounced even after, does carry with it certain advantages. A regulator that focuses on a particular sector of the financial system – e.g., commercial banks, investment banks, or insurance companies – is able to develop over time a "deep" expertise when it comes to understanding the value added by and the challenges faced or raised by the businesses that operate in that sector. It is also able to develop an ongoing rapport with the firms that it regulates, which can assist it in gathering information and responding to regulated entities' concerns while also reassuring those entities' of the regulator's good faith.

At the same time, however, when firms in one sector begin increasingly to offer new products and services reminiscent of those more familiar to another sector,²⁶ the traditional argument in favor of siloed regulators begins to lose purchase. When, in addition, firms in one sector begin adopting risk-occasioning practices long familiar to another sector,²⁷ the siloed

²² FHA is the Federal Housing Authority, which since 1934 has provided default insurance on qualifying mortgages (the now familiar 30-year fixed rate was its invention) and assisted with home refinance and home borrower education. FHFA is the Federal Housing Finance Agency, which primarily regulates such secondary mortgage market makers as Fannie Mae.

²³ The SEC, again, is the Securities and Exchange Commission, which since 1934 has regulated the securities markets, the broker-dealer firms that operate in those markets, and the investment companies, including mutual funds, that specialize in investing in those markets. It also regulates those who serve as investment advisors to such companies, as defined by the Investment Advisors Act of 1940.

²⁴ The CFTC is the Commodity Futures Trading Commission, which is the SEC's counterpart in the derivatives markets.

²⁵ SIFIs are "Systemically Important Financial Institutions," a category that embraces two subcategories of institution defined under the Dodd-Frank Act, more on which *infra*.

²⁶ As in the case, for example, of money market mutual funds (MMFs) increasingly offering bank-like products and services through the 1980s and after.

²⁷ As in the case, for example, of insurance companies funding long maturity investments with short maturity borrowings like repos or cashable policies.

approach to financial regulation becomes not only less justifiable, but downright dangerous.²⁸ Finally, where “financial convergence,” as it was called in the 1990s, involves not only cross-sectoral product- and transaction-replication but also cross-institutional transacting or affiliating, yet another challenge is posed to the siloed form of financial regulation, for the risks associated with one sector’s business model can now be transmitted – if not indeed intentionally transferred – to another, less appropriately regulated sector’s balance sheets.

The dangers of siloed financial regulation became particularly apparent during the financial meltdown of 2008. Many nonbank financial institutions, for example, found means of borrowing short term in order to invest long term, this with a view to profiting on the spreads between low short term borrowing costs and higher long term investment returns. In so doing these institutions effectively replicated the maturity-transformation properties of bank balance sheets, thereby rendering themselves vulnerable to bank-run-reminiscent liquidity risk. The problem, of course, was that these institutions were neither protected against such risks as banks are by deposit insurance, nor compensatingly regulated against such risks as banks are by their insurer, the FDIC. Indeed in many cases, these institutions’ regulators weren’t even primed to be on the lookout for maturity-mismatch-associated liquidity risk. Lehman Brothers, an investment bank, was of course the poster child for this vulnerability.

Relatedly but distinctly, by 2008 many financial firms of many nominally distinct kinds had become so interdependent upon one another’s solvencies that the failure of one firm of one type could significantly threaten the solvencies of other firms of other types. In some cases these webs of interdependency had become so dense, with so many distinct forms and sheer quantities of interconnection, that no regulator of one institution type was able adequately to assess such institutions’ vulnerabilities to the possible failures of other firms of other types. Here the poster child surely was American Insurance Group (AIG), which had purported to insure multiple other institutions against risks associated with the assets they carried, such that its insolvency threatened the solvency of countless other large institutions. But the money market mutual funds that had made short term loans to institutions like Lehman were likewise conspicuous instances of this form of vulnerability, and their looming failures in 2008 were particularly ominous in

²⁸ For regulators in the newly risky sector will not, unless they communicate well, know immediately how best to regulate the new sources of risk in the way that their more seasoned peers in other sectors do.

view of their having come to function as bank substitutes for millions of Americans by the time of the crisis.

It is against this backdrop that Congress devoted the very first sections of The Dodd-Frank Act – Title I – to the FSOC. There was broad consensus post-2008 that the crisis had conclusively demonstrated once and for all that the eccentric and haphazardly siloed character of American financial regulation was dysfunctional, no longer adapted to a no longer siloed financial system. But that left a question: what form should non-siloed regulation take? Many suggested that a single financial regulator – something like Britain’s or Japan’s Financial Service Authority (FSA) should be instituted, and that this plenary regulator would work in tandem with the Fed as its regulatory twin.²⁹ Dodd-Frank’s framers, however, operated in a more conservative, pragmatically incrementalist manner. They did so by maintaining the separate sectoral regulators, but bringing them together into a periodically convening single council in which they could all “get on the same page,” so to speak, where developing an overview of the financial system as a whole and its systemic risks were concerned.

In constructing the FSOC in this particular manner, Dodd-Frank endeavors to “have the cake and eat it too” in respect of the “depth versus breath” dilemma rather as the APA does in respect of the “efficient governance versus constitutional safeguards dilemma.” This is readily apparent both in the structure and in the functions and authority conferred by Dodd-Frank on the FSOC. With respect to structure, the Council comprises all ten of the primary federal financial regulators, each of whom has voting authority on the Council, including the Chair of the FRB and the Secretary of the Treasury.³⁰ It also includes five non-voting members from government entities lacking in federal regulatory jurisdiction, in order to have the benefit of their knowledge of other corners of the financial system.³¹ This structure is not unlike that of other interagency government councils such as the National Security Council,³² suggesting that Congress in

²⁹ Such is the so-called “twin peaks” model of financial and monetary regulation, pursuant to which the “prudential regulator” maintains financial stability while the central bank maintains monetary stability. See Hockett, *Macroprudential Turn*, *supra* note 7.

³⁰ See 12 USC 5321(b)(1).

³¹ See 12 USC 5321(b)(2).

³² See 50 USC 3021(a),(b) (Supp. I 2013).

enacting Dodd-Frank had taken specific cognizance of the potentially cataclysmic character of financial “meltdowns” – the latter term imported, of course, from the nuclear power industry.

With respect to functions and authority, the FSOC plays two principal roles and is endowed with only such authority as is necessary to carry out those roles. The first role is that of identifying “risks to the financial stability of the U.S. that *could* arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies” (emphasis supplied), and responding to such threats by making recommendations to Congress, to the separate regulators whose head constitute the Council itself, or both.³³ The authority that it has in connection with this role is that of collecting information from regulators and market participants that can aid it in its systemic-risk-monitoring tasks – information that the new Office of Financial Research (OFR), FSOC’s ancillary institutions also instituted by Dodd-Frank, assists it in gathering and assessing.³⁴

The second role played by FSOC is complementary to the first: it is to identify particular *firms* whose size, operations, or connections could render *them themselves* “threat[s] to the financial stability of the U.S.” in the event of insolvency.³⁵ These are the so-called “Systemically Important Financial Institutions,” or “SIFIs.” Designating them is one instance of FSOC’s more general mandate to “require supervision ... for nonbank financial companies that *may* pose risks to the financial stability of the United States.”³⁶ The authority that FSOC has in connection with this role is, again, to gather information germane to its deliberations over whether to designate any firm a SIFI.³⁷

SIFI designation carries with it two important consequences for any designated firm. For the designation activates authority on the part of the Fed to take two important regulatory measures. The first is to promulgate enhanced prudential standards akin to those to which it already subjects large, interconnected banks under its authority as administrator of the Bank

³³ See 12 USC 5322. See also FSOC’s rule promulgated under this authority, requiring the Council to conduct “robust analysis of the *potential* threat that ... nonbank financial companies *could* pose to U.S. financial stability.” 12 CFR Part 1310 (emphases supplied).

³⁴ *Id.*

³⁵ See 12 USC 5323(a)(1). Once again “could” is the operative word.

³⁶ See 12 USC 5323(a)(1) (emphasis again supplied).

³⁷ See sources cited *supra*, note 33.

Holding Company Act of 1956 and the Gramm-Leach-Bliley Act (GLBA) of 1999.³⁸ The second is to require designated firms to map their complex asset and liability structures carefully in advance so that the FDIC can liquidate them in an orderly manner in the event of an insolvency – the so-called “living will” and “orderly liquidation” authorities (OLA) laid out by Dodd-Frank Title II.

These two consequences are intimately related, which is part of why they appear consecutively in Dodd-Frank’s very first two Titles. Their relation is this: they are meant to operate from both the front-end (enhanced prudential regulation) and the back-end (orderly liquidation) to prevent a cascade of 2008-style bailouts from happening ever again. Enhanced prudential standards are aimed to prevent externality-causing insolvency. Orderly liquidation is aimed at preventing the need, in the event that insolvencies do occur, to extend federal moneys to “prop up” failing institutions so as either to prevent or to postpone failure when such would impose catastrophic costs upon innocent third parties.

It is no accident that both the FSOC’s very existence and these two primary functions are laid out in Dodd-Frank’s very first two Titles. They are the single most important set of contributions made by Dodd-Frank itself, addressed to what were universally acknowledged to have been the principal two weaknesses in our siloed form of financial regulation as revealed by the crisis of 2008. The first of those, again, was the fragmented system’s failure to see in advance that nonbank institutions were now occasioning risk of a kind that the banking system alone had done back in the days prior to FDIC deposit insurance and expedited liquidation authority. The second, relatedly, was this same system’s incapacity to resolve failing nonbank institutions in the same expeditious manner as it could banking institutions – notwithstanding that these nonbank institutions, aptly and now famously dubbed “shadow banks” by my friend Paul McCulley, just *were* the present era’s new banks where liquidity risk and messy liquidation risk were concerned.

The FSOC’s SIFI designation regime, then, lies at the very core of Dodd-Frank. It is narrowly targeted at preventing bank-like risks and associated systemically catastrophic bank-like failures from occurring among nonbank institutions, when these come to replicate banks in

³⁸ Id.

their systemic significance. In this respect SIFI-designation can be viewed as a sort of “flip side” to chartering decisions made by the OCC when promoters seek permission to start up new banking organizations. These charters are matters of privilege, not right, for systemic consequences – and hence potential public expenditures – follow the granting of bank charters. The strings that come attached to national bank charters include subjection to enhanced forms of prudential regulation to which other firms are not subject, as well as subjection to FDIC-style expedited liquidation authority in the event of insolvency notwithstanding those forms of regulation.

SIFI-designation functions as a sort of retroactive attachment of similar strings when it turns out that a financial institution that does not call itself a bank nevertheless *amounts* to a bank where its systemic importance is concerned. It is accordingly no surprise that the degree of discretion legally afforded FSOC SIFI-designation is reminiscent of that afforded OCC decisions to grant or refrain from granting bank charters. (In fact, as I’ll indicate, the SIFI-designation process is actually much more painstakingly bounded than are OCC chartering decisions – but this is by statute rather than court-developed rule.) Nor is it any surprise that, just as those who do not operate like banks need not procure bank charters, so do large financial institutions that do not impose bank-like risks upon the broader financial system not need worry about SIFI designation.

In any event, to undo or substantially impede the SIFI-designation and associated orderly liquidation regime would be effectively to return to the financial system we lived under prior to 2008. Fine-tuning it to enable it to function with yet greater effectiveness without ignoring the constitutional settlement described in Section A above, or to afford yet more constitutional safeguards without impeding its effectiveness, would be one thing. Throwing constitutional cautions or regulatory efficiency to the winds would be another. Any future tinkering with FSOC’s structure, functions, or authorities must take very special care that would-be improvements not upset the delicate constitutional/efficiency balance, or the nearly as delicate depth/breadth balance, that we have striven so hard to establish and maintain.

As things stand, I believe both balances well maintained by the current FSOC SIFI-designation regime. For the protections against arbitrariness and capriciousness in the designation of SIFIs are much more robust even than we find in the case of OCC bank-

chartering. For one thing, final SIFI-designation requires a supermajority vote – at least 2/3 – of the FSOC’s members, including an affirmative vote by the Treasury Secretary.³⁹ For another thing, SIFI designation requires separate consultation with any nonbank SIFI’s sector-specific regulator,⁴⁰ and annual reevaluation of its designation decision.⁴¹ For yet another thing, Dodd-Frank affords detailed guidance as to what sorts of consideration the FSOC is to take into account in determining SIFI status. Among these are the exposure of the prospective SIFI’s creditors, counterparties, investors, or other market participants to its possible failure; the proneness of the SIFI’s assets to “firesale”-style price plummets if liquidated quickly; and the degree to which market participants rely upon the prospective SIFI’s continued functioning in order to access a critical function or service.⁴²

Finally, Dodd-Frank on the one hand, and the FSOC itself via its rulemaking on the other, imposes a multi-step sequence upon the process of SIFI-determination, each step aimed both at enhancing the aptness of decisions and the due process interests of prospective SIFI-designees.⁴³ At Stage 1 the Council applies uniform and publicly available quantitative thresholds to develop a broad list of firms that *might* warrant SIFI designation. It operates pursuant to six quantitative thresholds calculated under six qualitative criteria, and posts on its website the components of the six thresholds, its methodologies for calculating them, and its methods of estimating them when less than complete data is available.⁴⁴

At Stage 2 the Council analyzes, on an individualized basis, companies identified in Stage 1. It now employs both quantitative and qualitative methodologies to determine company risk profiles. It may use non-public information at this point in the process where confidences need be maintained, including confidential supervisory information that a firm’s primary regulator has supplied. The Council now notifies a company within 30 days of an analytical team’s being assembled to begin active review of the company. It also provides to the company

³⁹ See 12 USC 5323(a)(1).

⁴⁰ See 12 USC 5323(g).

⁴¹ See 12 USC 5323(d).

⁴² See 12 USC 5323(a)(2), (b)(2).

⁴³ See 12 USC 5323(e); 12 CFR Part 1310, Subpart C. Also Staff Guidance, Financial Stability Oversight Council, Methodology Relating to Stage 1 Thresholds (June. 8, 2015), available at <http://www.treasury.gov/initiatives/fsoc/designations/Documents/FSOC%20Staff%20Guidance%20-%20Stage%201%20Thresholds.pdf>.

⁴⁴ See Staff Guidance, id.

all “primary public sources of information being considered.” The Council also commences engagement with prospective SIFIs’ primary regulators at this stage. Before any final decision is made to move the company to Stage 3, the company is given the opportunity to present information to the Council. If the company announces publicly that it is under active review, the Council also confirms that such review is ongoing if requested by a third-party.⁴⁵

Finally at Stage 3, FSOC contacts non-bank financial company that it believes merits further review to collect information directly from the company that was not available in the prior stages. An analytical team staff then meets with the company’s representatives to explain the evaluation process and the framework for the Council’s analysis. The company is now also afforded an opportunity to submit written materials pertinent to the FSOC’s determination. The Council may also grant any timely request for an oral hearing or a hearing before the Council members. The Council also disclose the numbers of non-bank financial companies that, since the publication of its previous annual report, it has voted to advance to Stage 3, not to advance to Stage 3, and to designate a SIFI.⁴⁶

This three-stage process, which in view of the internally sequenced character of each stage itself amounts to something more like a ten-stage process, is much more detailed and solicitous of aggrieved parties’ concerns than is that, say, of bank charter decisions, which under the APA itself is reviewable by courts only under the highly deferential “arbitrary and capricious” standard.⁴⁷ It is scarcely surprising, then, that Dodd-Frank itself specifies that this standard also is applicable to review of FSOC SIFI-designations.⁴⁸ Indeed, in view of the complex, technical, and dynamic nature of the subject of FSOC regulatory expertise,⁴⁹ as well as the consequently unavoidably predictive character of its determinations,⁵⁰ court review of its

⁴⁵ See sources cited *supra*, note 43.

⁴⁶ *Id.*

⁴⁷ See *Camp v. Pitts*, 411 US 138 (1973). On the deference mandated by the arbitrary and capricious standard, see *Motor Vehicle Mfrs. Ass’n of the U.S. v. State Farm Mut. Auto. Ins. Co.* 463 U.S. 29, 43 (1983) (Court “is not to substitute its judgment for that of the agency.”); also *Rural Cellular Ass’n v. FCC*, 588 F.3d 1095, 1105 (D.C. Cir. 2009).

⁴⁸ See 12 USC 5323(h).

⁴⁹ See *Cablevision Sys. Corp. v. FCC*, 597 F.3d 1306, 1311 (D.C. Cir. 2010); *Domestic Sec., Inc. v. SEC*, 333 F.3d 239, 248 (D.C. Cir. 2003); *Appalachian Power Co. v. EPA*, 251 F.3d 1026, 1035 (D.C. Cir. 2001).

⁵⁰ *Rural Cellular*, *supra* note 47; also *BellSouth Corp. v. FCC*, 162 F.3d 1215, 1221 (D.C. Cir. 1999); *Melcher v. FCC*, 134 F.3d 1143, 1151 (D.C. Cir. 1998).

decisions are meant to be highly deferential even relative to the already deferential baseline of ordinary cases subject to arbitrariness and capriciousness review.

In light of all of this background, I have no doubt whatever that no federal court in the U.S. would find anything constitutionally or regulatorily problematic about the structure or functions of the FSOC as a general matter. Nor do I believe that a court would find any regular exercise of its authorities by the FSOC legally problematic save in the most extreme and egregious disregard of or violation of the standards that I have just articulated. I also suspect that the vast majority of finance-regulatory experts would agree that the FSOC as currently constituted represents a reasonably conservative, pragmatically incrementalist move in the direction of non-siloed regulatory consolidation at the present stage of our financial and finance-regulatory development. I doubt that many, if any, finance-regulatory experts would argue that we should either return to the pre-2008 environment of siloed regulators or rocket immediately forward to a single, FSA-style prudential regulator.

In short, then, I think that courts will agree that the FSOC regime is consistent with our longstanding settlement with respect to the balance of regulatory efficiency and constitutional constraint, and that finance-regulatory experts will agree that the same regime is consistent with the balance we desire between “deep” sectoral expertise and “wide” cross-sectoral understanding. This does not, however, by any means entail that the present regime is perfect. Certainly constructive criticisms and corresponding proposals for improvement can in good faith be made. That takes me to some of the specific criticisms that I take to have prompted today’s hearing.

III. CRITICISMS OF FSOC THAT APPEAR TO HAVE OCCASIONED TODAY’S HEARING

Today’s hearing appears to be primarily concerned with the FSOC’s SIFI-designation process, pursuant to which four designations have been made to date – those of AIG (of 2008 crisis renown), General Electric Capital Corporation, Inc. (“GE Capital”), Prudential Financial, Inc. (“Prudential”), and MetLife, Inc. (“MetLife”).⁵¹ They seem to have been occasioned in part

⁵¹ See Financial Stability Oversight Council, Designations, available at <http://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx>. For MetLife’s Designation in particular, see Basis for the Financial Stability Oversight Council’s Final Determination Regarding MetLife, Inc., December

by criticisms levelled at FSOC by MetLife in particular, the only SIFI-designee to have challenged its designation in court.⁵² In addition to MetLife's criticisms, there have been several others levelled by *Amici Curiae* offering opinions to the court on behalf of MetLife in connection with its case. As suggested above, I do not believe any of these criticisms to have legal merit as any court is apt to define it. This does not preclude some such criticism's possibly having policy merit, however, so I will address each criticism from each of those angles.

A. Separation of Powers

In its complaint, MetLife attempts to impugn the constitutional propriety of the FSOC's very existence, arguing that the "extraordinary design in the Dodd-Frank of FSOC itself" constitutes a violation of the Constitution's separation of legislative, executive, and judicial powers in Articles I through III of the Constitution.⁵³ The Complaint elaborates by explaining that FSOC "identifies individual companies for designation, establishes the standards that govern the designation decision, and then sits in judgment of its own recommendations, relying each step of the way on the same staff that identified the company for designation in the first place."⁵⁴ This is a surprising claim because it both "proves too much" and appears to call into question the APA settlement itself.

As noted above, that about executive agencies which occasioned concern in the first place, commencing in the late 19th century, was their combining, in the name of efficiency, executive, quasi-legislative, and quasi-adjudicative functions within the same organ of government. The means we chose to prevent such arrangements' violating constitutional separation of powers while streamlining governance were those of the APA and associated caselaw – intelligible legislative directives, public notice and comment in rulemaking, and recourse to the courts when in-house adjudications did not afford satisfaction. There is no argument that the FSOC's mandate and procedures as prescribed by Dodd-Frank are in any way out of step with that settlement, unless the "same staff" observation is meant to make the

18, 2014, available at

<http://www.treasury.gov/initiatives/fsoc/designations/Documents/MetLife%20Public%20Basis.pdf>.

⁵² See *MetLife, Inc. v. Financial Stability Oversight Council*, No. 15-45 Civ. (D.D.C., filed Jan. 13, 2015), available at <http://www.chamberlitigation.com/sites/default/files/cases/files/2015/Complaint%20--%20MetLife%20v.%20FSOC%20%28DDC%29.pdf> (hereinafter "Complaint").

⁵³ Complaint, *id.*, at 6-7; also at 73, 76.

⁵⁴ *Id.*

difference. But no reason is given as to why the latter would or should in the absence of formal in-house adjudication; and the fact that FSOC is no more required to provide formal adjudications, complete with administrative law judges (ALJs) than is the OCC with respect to bank chartering decisions suggests that no legal such reason could ever be found.⁵⁵

MetLife's quarrel seems accordingly to be with our longstanding settlement itself. It would seem as applicable to each of the distinct regulatory agencies whose heads constitute the Council as it is to the Council itself. Indeed it would seem applicable to all administrative agencies, and in that sense to the post-19th century administrative state itself. No court is going to dismantle the latter – nor, of course, is any Congress. The complaint is quite literally a nonstarter. This is not to say, however, that there is no reason for Congress to consider requiring formal adjudications with respect to all agency actions within agencies themselves, and to require that these be conducted by specialized ALJs as occurs within some agencies. I have no opinion to offer on whether this would be a good idea or not, and leave it to Congress and administrative law scholars to vet any such prospect.

B. Due Process

MetLife also argues that the FSOC SIFI-designation process is incompatible with 5th Amendment due process rights, on several grounds.⁵⁶ The first ground is simply a restatement of the aforementioned separation of powers claim, and accordingly fares not better as a legal matter.⁵⁷

The second ground is that “FSOC has never identified the thresholds that result in SIFI designation and how the various statutory and regulatory factors are being balanced against one another,” which MetLife argues prevent “the government ... provid[ing] adequate notice of what is required and what is prohibited,” as well as from “provid[ing] explicit standards for those who apply them.”⁵⁸ This argument too “proves too much,” inasmuch as it appears to claim that due process requires not only regulatory agencies, but also Congress, to provide precise algorithms enabling machine calculations of outputs of all multifactor “totality of the circumstances”

⁵⁵ See again *Camp v. Pitts*, supra note 47.

⁵⁶ Complaint, supra note 52, at 73-75.

⁵⁷ Id. at 73.

⁵⁸ Id. at 74.

inquiries and “balancing tests” found in statutes, regulatory provisions, and court-developed criteria for the application of legal concepts.

That is of course wildly inaccurate as a statement of law, as not only the National Bank Act’s and OCC’s associated criteria in deciding on bank charters make clear,⁵⁹ but also hundreds if not thousands of other longstanding statutory, regulatory, and court-developed pragmatic balancing tests do too.⁶⁰ It also is doubtful that any legislator would wish to *make* any such standard the law, inasmuch as this would seem to require that all proper legal questions now ultimately decidable by judges be decidable by computing machines. This is not to say that something resembling a more algorithmic form of clarity might not be feasible and desirable with respect to some regulatorily important questions, however, and indeed it even is there to be had in connection with some – including some addressed by FSOC itself.⁶¹ Whether and where to mandate more such machine-calculable precision is a difficult question whose answer is apt to vary from regulatory context to regulatory context. But neither the question nor its answer will likely have anything to do with due process as contemplated by our Constitution and interpreted by our courts.

The third ground on which MetLife claims FSOC to have violated its due process rights is that FSOC “repeatedly and improperly denied MetLife access to the full record on which its Notice of Proposed Determination and Final Designation were based.”⁶² This claim is effectively a rehash of the first ground and, accordingly, the separation of powers argument as well. The reason is that, again, FSOC is no more constitutionally or statutorily required to conduct a formal adjudication of SIFI determinations than is the OCC of bank chartering decisions.⁶³ Hence there is no requirement that every internal deliberation or piece of evidence that the Council found germane in making its determination be made public.

⁵⁹ See 12 USC 1816; 12 CFR 5.20(c); and *Camp v. Pitts*, supra, note 47. The criteria, which are not assigned comparative weights or lexicographically ordered, and no one of which is categorically dispositive, are (1) the bank’s future earnings prospects, (2) the general character of its management, (3) the adequacy of its capital structure, (4) the convenience and needs of the community to be served by the bank, (5) the financial history and condition of the bank, and (6) the regulatory compliance to date of the bank.

⁶⁰ Consider veil-piercing in corporate law, for example, pursuant to which courts look to unobserved corporate formalities, comingled funds, undercapitalization, assumption of risk by creditors, and other factors in determining whether to disregard the limited liability of corporate owners in some cases.

⁶¹ See, e.g., supra, note 44, and accompanying text.

⁶² Complaint, supra note 52, at 74.

⁶³ See again *Camp v. Pitts*, supra, note 47.

Nor is Congress's declining to prescribe differently in Dodd-Frank particularly surprising. In examining a prospective SIFI's interconnections with other financial institutions, the FSOC accesses proprietary information about other private institutions with which the prospective SIFI transacts, some of which is no business of the prospective SIFI or of other private parties. Similar remarks hold of some of the data and opinions FSOC receives from other regulators that have interacted with the prospective SIFI. Hence there are good policy reasons for neither Congress's nor the courts' ever having mandated that all information whatever that enters into a regulator's deliberations in deciding how to regulate a particular institution be turned over to any regulated entity that demands it.

Congress could of course decide that a regulated entity's desire of all such information trumps the privacy interests of all other private institutions directly or indirectly affected by the regulated entity's financial health. But I doubt that would go over well with the other institutions in question, or that most legislators would ever decide that it is a categorically good idea.

C. Arbitrariness, Capriciousness, "Irrationality"

In addition to its "constitutional" arguments, MetLife argues that FSOC's SIFI-designation fails the highly deferential "arbitrary and capricious" standard of review prescribed by the APA in cases such as its own.⁶⁴ It does so on multiple grounds that it would be tedious to rehearse and assess comprehensively here – that's what the trial process is for – so instead I shall point simply to several related themes that appear to recur through most of the separate counts asserted by MetLife against FSOC. The themes I identify are worth pointing out because, even while I am quite confident they will avail MetLife nothing as a matter of law in the courts, one can imagine good faith disagreements of policy over how best to frame or amend law going forward in light of them.

One prominent theme both in MetLife's complaint and in the writings of some who support MetLife is that of the "speculative" character of FSOC's modeling of hypothetical worst-case scenarios in determining whether a MetLife insolvency event could imperil the stability of the larger financial system.⁶⁵ As a matter of law, these claims are likely to go nowhere – both in

⁶⁴ Complaint, *supra*, note 52, at 40-72.

⁶⁵ See, e.g., *id.* at 47 (Count 4), 51 (Count 6)

virtue of the “could” and “may” language that permeates the statutory guidance provided FSOC by Congress,⁶⁶ and in virtue of FSOC’s having carefully traced specific plausible transaction paths with a view both to known types and to known volumes of financial claims held by, and held against, MetLife.⁶⁷ As a matter of policy, however, it is worth considering why it might be that Congress drafted Dodd-Frank Title I so as to mandate FSOC assessment of possible but not certain scenarios.

Some who complain of modeling like that done by FSOC appear to want to require that FSOC and other regulators assign precise and determinate actuarial likelihoods to all contemplated scenarios, so as to render assessments of dangers more precise. Others appear to want even more than this, suggesting that only likelihoods beyond a certain threshold – e.g., 10% – should be considered plausible concerns. Congress could of course attempt to mandate something like this in connection with all manner of risk regulation in all manner of context, from environmental law to nuclear regulation to financial regulation. It would not likely prove successful, however, for the quite simple reason that actuarial probabilities simply are not available for many, if not most, of the most troubling prospects. “Precisely” how likely, for example, was the 2008 crash? How about BP’s oil spill in the Gulf of Mexico two years later? How would we ever have calculated a number?

The difficulty of assigning precise probability measures to the possible outcomes also undermines prospective requirements that some probability threshold be crossed before an undesired outcome is deemed “plausible,” for the obvious reason that there would seem no basis on which to be confident that any determination that the ersatz-precise threshold had been reached is in fact correct. But there is also another problem with any such requirement: even in cases where a probability measure might reasonably be derived, the actual magnitude of the possible loss might *not* be. Consider the calamity of September 11, 2001, for example. It is hard to imagine how anyone might have assigned a precise numeric probability to measure to the possibility of that event prior to its happening; it is at least as hard to imagine how anyone one might have calculated a dollar value (or “disvalue”) assignable to the event even were s/he able to assign a precise probability.

⁶⁶ See *supra*, notes 33-36, and accompanying text.

⁶⁷ See MetLife Designation as cited *supra*, note 51.

It would surely be incorrect, however, in the face of these observations to conclude that it is somehow “irrational” to attempt to provide against occurrences like 9/11. Yet that is what calling regulatory measures not advocated by reference to precise expected value or disvalue measures “arbitrary and capricious” amounts to. Our law accordingly declines to call them that for good reason. But so should we, I suggest, when it comes to determining what the law *ought* to mandate.

D. Cost-Benefit Analysis

Closely related to the demand for “non-speculative” modeling of risk scenarios is that for “cost-benefit analysis” (CBA) of prospective regulations or determinations. MetLife and some of its supporters seem to want this of FSOC.⁶⁸ As with the demand for “non-speculative” risk modeling, so here the demand is a non-starter if proffered as an interpretation of the “arbitrary and capricious” standard of review – and for essentially the same reasons. Also as with that case, however, I think it ill-advised as a policy prescription as well. Consider again the case of 9/11, for example. In the wake of that calamity, Congress enacted the U.S. Patriot Act, which worked a massive overhaul of the domestic security regime, including a great deal of consolidation of previously fragmented law enforcement agencies. The comparison to Dodd-Frank in the wake of 2008 is actually quite striking.

Now ask whether it would have made sense to subject the Patriot Act to CBA. To go about such an analysis, one would have to calculate the likely costs imposed by the enactment and compliance therewith, then compare these to the likely benefits brought by it. To calculate the latter one would have to calculate (a) the likelihoods of all possible terrorist acts – plane crashes, bombings, shootings, nuclear “dirty bombs,” etc. – at which the Patriot Act Regime would take aim, (b) the “costs” – monetary?, psychological?, other? – of such acts when they succeeded, and (c) the likelihood, in connection with each such possible act, that the Patriot Act regime would prevent or mitigate it – and if the latter, by how much.

The suggestion seems absurd on its face. It is no different where what is in contemplation is not nuclear core meltdowns but financial system meltdowns. *Attempts* at cost-benefit analysis can be useful exercises in such cases, if only to begin to get a handle on the

⁶⁸ See, e.g., Complaint, *supra*, note 52, at 71 (Count 7).

many elements that might jointly constitute the anticipated problem. But to require that the “benefits” outweigh the “costs” in such cases before regulating can proceed, as if the “exercise” had yielded actual probability-weighted values, would itself amount to a sort of legislated suicide pact.

E. Compliance Costs

A final theme I have seen aired in connection with the MetLife case constitutes a proper part of the CBA motif. That is the theme of “compliance costs” and the likelihood that these will be “passed on to consumers,” the latter apparently meant to be taken for damning.⁶⁹ Because it is a proper part of the CBA claim, this claim has no legal significance where the litigation of FSOC SIFI-designations is concerned. It does have a policy significance, however, that I think worth commenting on.

The principal compliance cost that a large financial institution designated a SIFI will incur is that of having to maintain higher capital levels which serve both to buffer creditors of the institution against loss occasioned by insolvency and to lower the leverage rates that raise insolvency risk. Limiting leverage in this way of course potentially lowers profits and hence shareholder returns, but this is simply another way of saying that shareholder opportunities to profit by imposing risk upon creditors will be lessened. Since the creditor cascade effects that interconnectedness enables, and that ultimately prompt SIFI-designation in the first place, amount to that risk’s spreading beyond primary creditors, it is also another way of saying that shareholder opportunities to profit by imposing negative externalities upon innocent third parties will also be lessened. But now we should ask ourselves, is this not precisely the *point*? In other words, is not the whole object of post-crisis financial reform legislation like Dodd-Frank to put an end to the socialization of risks wrought by those who reap merely privatized gain?

Our objection to “too big to fail” in 2008 was precisely the fact that “we, the people” had to swallow the losses occasioned by a comparative few who “minimized compliance costs” precisely by externalizing their risks upon others and thereby maximized gains. The gains, in other words, they kept for themselves and didn’t share; the losses, by contrast, they shared – indeed they deliberately exported – to all of us. The only way to avoid that obnoxious outcome,

⁶⁹ Again see, e.g., Complaint, *supra*, note 52, at 71 (Count 7).

of course, is to prevent firms being too “big,” in the relevant sense, in the first place. That is, it is to eliminate their capacity to externalize costs upon innocent third parties – costs the need to avoid which prompt “*bailouts*” in the first place. But to do this just *is* to lower their profits, for externalizing costs in the form of systemic risk is the *source* of a large chunk of their profits.

When an institution like MetLife gives voice to the truism that greater prudential risk regulation through higher capital requirements represents a “compliance cost,” then, we should remember that this is simply another way of saying that designating it a SIFI will render it no longer “too big to fail.” For it will then have but two choices, neither of which will offer it the option of remaining too big to fail: either it restructures so as to avoid capital regulation and no longer pose systemic risks of the kind that necessitate bailouts in the first place, or it lives with the enhanced capital standards that prevent its failing and thereby avoids necessitating bailouts. It is that simple.

I’ll close with an analogy that might render the point more graphically clear. If you irresponsibly play with matches in your barn and inadvertently set it alight, we are less likely to rescue your barn should it be isolated than if it is shedding sparks that can set other, innocent people’s barns alight. If the latter prospect is that which occurs, such that we *must* save you in order to save innocent others, we are apt to grow irritated in the event you repeat the offense. At some point we will become so impatient that we will issue you this ultimatum: either move your barn far away where its burning will not affect others, or you coat it with new flame-retardant paint straightaway. We are unlikely to be moved if you now complain that this confronts you with a “compliance cost.” That cost is precisely the point of our ultimatum. Henceforth either you, not us, now incur the cost of fire-prevention, or you move your barn to where your match games inside it won’t threaten the rest of us.

CONCLUSION

I hope that the foregoing written testimony serves as a useful supplement to my oral testimony before you today. Please do not hesitate to let me know if I might be of further assistance. I am happy to elaborate further on anything said orally or written above in this supplement, as I have tried to keep myself as brief as possible in both. Thank you again for inviting my thoughts on the matters under discussion.

TESTIMONY OF JONATHAN R. MACEY

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Before the
United States House of Representatives
Committee on Financial Services
Subcommittee on Oversight and Investigations
Hearing on
“Oversight of the Financial Stability Oversight Council: Due Process and
Transparency in Non-Bank SIFI Designations”

Thursday, November 19, 2015
Room 2128 Rayburn House Office Building

Background

I am the Sam Harris Professor of Corporate Law, Corporate Finance, and Securities Law at Yale University, and a Professor in the Yale School of Management. He is the author or co-author of several books on corporate governance and banking laws, including *Macey on Corporation Laws, Corporations: Including Partnerships and Limited Liability Companies*, and *Banking Law and Regulation*. His work on risk includes “Regulation and Disaster: Some Observations in the Context of Systemic Risk,” 1998 Brookings-Wharton Papers on Financial Services 405 (with M. Wayne Marr and S. David Young), and “The Glass-Steagall Act and the Riskiness of Financial Intermediaries,” 14 Research in Law and Economics 19 (1991). Section 113 of the Dodd-Frank Act is a risk-regulation statute. It directs the Financial Stability Oversight Council (“FSOC”) to assess two particular form of risk to “the financial stability of the United States.” 12 U.S.C. § 5323(a)(1). The FSOC’s actions thus far fail to take account of widely accepted principles of risk regulation that are relevant to its analysis.

Testimony

There are significant fairness and process concerns associated with the process by which non-bank financial institutions are designated as systemically important (SIFIs) by the FSOC. Among the most significant are: (a) the subjective nature of the designation process; (b) the ad hoc and idiosyncratic nature of the regulations that are imposed on SIFIs by the Fed after FSOC makes its designation.

The basic goal of due process, which is to support the rule of law by requiring that like case be treated alike and that rules be applied evenly and not on an individualized idiosyncratic basis is not being achieved by FSOC’s rulemaking. At a minimum, regulators should be required to state clearly and uniformly what criteria will lead to a SIFI designation. Further, once a company

has received a SIFI designation, the Fed should be required to negotiate an exit strategy, which would articulate what the firm must do to shed itself of the designation.

I. The FSOC's Analysis Does Not Consider Whether its Risk Scenarios Are Plausible

A. Basic principles of risk regulation require distinguishing plausible risks from implausible ones.

Every accepted form of risk regulation requires an assessment of not only the *consequences* of a possible contingency, but also its *likelihood*. There is much more to risk regulation than simply assuming that everything that *can* go wrong *will* go wrong, simultaneously, and treating that worst-case scenario as the baseline for regulation. Rather, an essential part of risk regulation is an objective assessment of *which risks to regulate*, based on empirical evidence and not just on the limits of the pessimist's imagination. The mere fact that a risk is hypothetically conceivable is not enough.

Context matters in assessing whether a particular risk is more than a speculative possibility. Just because flooding is a real risk in some circumstances does not mean it is a real possibility atop a mountain in the desert.

Even some risks that are *conceivable* are not conceivable *together*. For instance, some doomsday scenarios are simply inconsistent with one another. Equipment is not going to face extreme heat and extreme cold *simultaneously*.

Indeed, risk regulation could not be carried out without at least *some* consideration of probabilities. Part of risk regulation is assessing whether safety measures are adequate. That task becomes impossible if the inquiry includes the assuming that each and every safety measure will fail.

For these common-sense reasons, every accepted concept of risk regulation includes a component of risk *assessment*—including the risk-regulation concepts followed within the Executive Branch itself. According to the Office of Management and Budget, risk regulation entails risk assessment, risk management, and risk communication. In particular, risk assessment is a “useful tool for estimating the likelihood and severity of risks . . . and for informing decisions about how to manage those risks.” Proposed Risk Assessment Bulletin, 71 Fed. Reg. 2,600 (Jan. 17, 2006). Similarly, as early as 1997, the Federal Reserve Board emphasized the importance of risk assessment in the context of regulating “large complex institutions.” Fed. Reserve Sys., Framework for Risk-Focused Supervision of Large Complex Institutions 1 (1997). Specifically, the Board noted, risk assessment should “[c]onsider the relationship between the likelihood of an adverse event and the potential impact on an institution.” *Id.* at 25.

By definition, risk is about probability, and assessing the likelihood of any given risk is an essential element of risk regulation.

B. The FSOC Has Refused to Distinguish Plausible Risks from Implausible Ones

The FSOC’s analysis thus far has been inconsistent with this basic principle of risk regulation. For example, in its assessment of whether MetLife is a Systemically Important Financial Institution (SIFI) the FSOC overtly *refused* to give any consideration to whether its scenarios were even remotely likely to occur—whether to MetLife specifically, to an insurance company more generally, or to anyone. Fin. Stability Oversight Council, *Explanation of the Basis of the Financial Stability Oversight Council’s Final Determination that Material Financial Distress at MetLife Could Pose a Threat to U.S. Financial Stability and that MetLife Should be Supervised by the Board of Governors of the Federal Reserve System and Be Subject to Prudential Standards* 27 (Dec. 18, 2014) (“Final Basis”). The FSOC asserted that because the statute does not expressly incorporate a standard of likelihood, the FSOC may assess harm to the financial stability of the United States based on risks that lack even basic plausibility in the relevant context.

That contention gets the matter precisely backwards. Because distinguishing between plausible and implausible risks is such an essential part of any coherent system of risk regulation, there was no need for the statute to use the word “probable” or “likely”; the mere omission of such terms certainly does not require the FSOC obstinately to ignore reality. *See* Mem. of Points and Authorities In Support of Pl. MetLife, Inc.’s Cross-Mot. for Summary Judgment and In Opposition to Def.’s Mot. to Dismiss, or, In the Alternative, For Summary Judgment (Dkt. No. 40) at 27 (“MetLife Br.”). The statute, after all, requires the FSOC to examine “material financial distress *at* the U.S. nonbank financial company.” 12 U.S.C. § 5323(a)(1). Examining material financial distress *as it could plausibly occur at such a company* is thus required by the statutory text—just as one would expect in light of the background principles of risk regulation.

The FSOC’s decision to untether its analysis from reality led it to use highly unlikely scenarios to conclude that material financial distress *could* pose a threat to U.S. financial stability. For instance, the FSOC’s analysis placed a strong emphasis on the “run-on-the-bank” scenario. The FSOC suggested that “[b]eyond the direct effect of MetLife’s asset liquidation on the financial markets, a run on MetLife necessitating significant asset liquidations could spark a loss of confidence in the broader insurance industry, potentially leading to runs at other major insurers.” Final Basis at 145. The FSOC expressed the same concerns in its determination regarding American International Group and Prudential Financial. *See, e.g.,* Fin. Stability Oversight Council, *Basis of the Financial Stability Oversight Council’s Final Determination Regarding American International Group, Inc.* 7 (July 8, 2013).

But the “run-on-the-bank” scenario is wholly improbable in the context of an insurance company like MetLife, because of several important aspects of the insurance industry, discussed in more detail below. *See infra* at 6–14. The FSOC’s insistence that it can just assume that a “run-on-the-bank” scenario *will* occur in this context skips this crucial aspect of risk regulation—and renders its analysis fundamentally incoherent.

Another problem with the FSOC's analysis is that it does not account for the significant difference between runs on life insurers and runs on banks. In the United States, state regulators deal with a run on an insurer by seizing control of the insurer and freezing outflows. Because policyholders in insurance companies are not relying on money due to them for short-term liquidity needs, and because policyholders do not have the same immediate liquidity rights as do counterparties to repurchase agreements and depositors in banks, regulators have more options in dealing with those runs that do occur and runs can be managed by state regulators in a more orderly way.

The FSOC's rejection of risk assessment also caused it to ignore or minimize certain important protections, such as the use of collateral to mitigate risk. Risk regulators universally treat obligations secured by collateral as less risky than unsecured obligations; indeed, the quality of collateral *itself* may be a factor in risk assessment, as is the extent to which the collateral secures the obligation. Those well-accepted principles would simply evaporate in a regime where the regulator simply assumes that everything that can go wrong, will—*e.g.*, that good collateral will provide no more protection than bad collateral, or none. Accordingly, adherence to sound principles of risk regulation takes into account such risk-mitigation measures as collateral.

II. **The FSOC's Analysis Failed to Rationally Consider the Relevant Aspects of MetLife's Insurance Business.**

A. **Assessing The Risk of a Systemic Threat Akin to a Bank Run Requires an Understanding of Maturity Mismatch.**

Principles of risk regulation seek to understand the phenomenon of bank runs and to ascertain what causes or prevents them. Applying those principles requires an understanding of the concept of maturity mismatch.

Maturity mismatch refers to the difference between the maturities of a company's assets and liabilities. Liquidity risk refers to the risk that a company may not have sufficient funding to satisfy its short-term needs. Liquidity risk and maturity mismatch are closely related. Maturity mismatch "affects a company's ability to survive a period of stress that may limit its access to funding and to

withstand shocks in the yield curve.” Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. 21,637, 21,659 (Apr. 11, 2012). Hence, maturity mismatch may result in liquidity risk. See, e.g., Final Basis at 15. When the financial system encounters liquidity problems, companies are forced to sell their assets at an illiquidity discount (a price cheaper than would be available under conditions of liquidity), often referred to as a fire sale. In turn, lower asset prices lead to losses that deplete capital, further compromising liquidity. Franklin Allen & Douglas Gale, *Financial Intermediaries and Markets*, 72 *Econometrica* 1023 (2004). The result is a feedback mechanism.

Economists have found that maturity mismatch causes self-fulfilling panics among bank depositors. That happens in the banking context because of the very nature of banks, which engage in maturity transformation, turning short-term liabilities into longer-term assets. Put another way, a bank gives its demand depositors almost instant access to their funds, but it receives repayment of loans from consumers and businesses over a longer period of time. In this sense, the risk of maturity mismatch inheres in banks’ business model.

This results in two equilibria. First, “[i]f confidence is maintained, there can be efficient risk-sharing, because in that equilibrium a withdrawal will indicate that a depositor should withdraw under optimal risk-sharing. [Second, i]f agents panic, there is a bank run and incentives are distorted. In that equilibrium, everyone rushes in to withdraw their deposits before the bank gives out all of its assets. The bank must liquidate all its assets, even if not all depositors withdraw, because liquidated assets are sold at a loss.” Douglas W. Diamond & Philip H. Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, 91 *J. Political Econ.* 401, 403 (1983). Thus, “[i]lliquidity of [banks’] assets provides the rationale both for the existence of banks and for their vulnerability to runs.” *Id.*

In the financial sector, maturity mismatch is often measured by asset-liability duration and gap analysis. Put simply, duration analysis involves the calculation of the “time-weighted” maturity for each asset and liability of a company. In turn, gap analysis involves the estimation of differences

between the duration of those assets and liabilities. Thus, to measure maturity mismatch, one needs to examine a company's balance sheet closely. With life insurers, by contrast, it is not primarily their ability to do gap analysis and asset-liability management that makes them less susceptible to liquidity risk. Rather, the primary factors are: the fundamental structure of such companies' liabilities, particularly the relative stability of such liabilities; their long-term nature; and the reluctance of policyholders to liquidate due to surrender penalties, taxes, and other restrictions.

B. The FSOC's Analysis Fails to Consider Important Aspects of the Insurance Industry

In contrast to the business model of banks, however, maturity mismatch does not inhere in the business model of insurance companies, which are better positioned to pursue asset-liability management. Insurance companies operate by pooling and managing risk. While the structure of their balance sheet varies significantly by the type of insurance product, insurance companies tend to have long-term liabilities. In turn, insurance companies are well-positioned to estimate the duration of their liabilities and assign probability to payouts. Thus, MetLife describes itself as a "liability-driven business with long-term, predictable cash flows." Final Basis at 284. In principle, this allows insurance companies to buy assets with maturities that correspond to their liabilities and hold such assets to maturity. Moreover, unlike bank depositors, insurance policyholders have greater disincentives to early withdrawal, such as contractual penalties and loss of tax benefits, and thus are less likely to run on a moment's notice.

The differences in the business models of banks and insurance companies have three primary consequences. First, insurance companies can manage maturity mismatch significantly better than banks, and it is in the insurance companies' interest to do so. Unlike banks, maturity mismatch is not an inherent feature of insurance companies' business model. In fact, insurance companies pursue asset-liability management by matching the terms of their asset profile with those of their liability

profile. See Final Basis at 284. Therefore, even large insurance companies like MetLife are less likely to suffer from maturity mismatch.

Second, the insurance industry has far greater resilience against liquidity risk than other financial firms because their liabilities tend to be illiquid. The illiquid liabilities give them the opportunity to invest in longer-term assets. This characteristic of insurance not only reduces risk, it has a huge societal benefit in light of the great social value in having investors with longer-term time horizons. That benefit may be lost by treating insurance companies as if they were no different from banks.

Third, insurance companies are less susceptible to liquidity problems through their management of maturity mismatch. To begin with, insurance policyholders have greater disincentives to early withdrawal than bank depositors, including “federal income tax liability, federal income tax penalties, surrender penalties, and the loss of guarantees.” Fin. Stability Oversight Council, View of Director John Huff, the State Insurance Commissioner Representative 2 (Sept. 19, 2013). Moreover, insurance companies, especially life insurance companies, “are generally buy-and-hold investors, with the goal of generating predictable and stable income in the long run, and having sufficient funds available to pay claims when due.” National Association of Insurance Commissioners, Capital Markets Bureau, Securities Investment Strategies and Return on Invested Assets, available at http://www.naic.org/capital_markets_archive/140911.htm (last visited May 18, 2015).

In other words, insurance companies, given the nature of their business model, are less likely to face an immediate need for liquidity. MetLife, for instance, manages \$458 billion in its general account investment portfolio; over 20 percent of the portfolio’s securities are held in “[c]ash, short-term investments, U.S. Treasury securities, agencies, and agency RMBS.” Final Basis at 284. Thus, “liquidity risk is negligible in the insurance sector.” Guillaume Plantin & Jean-Charles Rochet, WHEN INSURERS GO BUST: AN ECONOMIC ANALYSIS OF THE ROLE AND DESIGN OF

PRUDENTIAL REGULATION 92 (2007) [hereinafter WHEN INSURERS GO BUST]. The dissenting and minority views on MetLife's designation voiced the same concern about the FSOC's reliance on speculative scenarios. S. Roy Woodall, the independent member with insurance expertise, stated that the FSOC's analysis under the Asset Liquidation Transmission Channel "relies on implausible, contrived scenarios as well as failures to appreciate fundamental aspects of insurance and annuity." Fin. Stability Oversight Council, Views of the Council's Independent Member Having Insurance Expertise 2 (Dec. 18, 2014). Adam Hamm, the State Insurance Commissioner Representative, noted that "the Basis implicitly assumes material financial distress at all insurance entities at the same time, yet the Basis cites no historical examples of that having ever occurred." Fin. Stability Oversight Council, View of Adam Hamm, the State Insurance Commissioner Representative 10 (Dec. 18, 2014).

B. Even On Its Own Terms, The FSOC's Analysis of Mismatch Fails to Comport With the Applicable Professional Standards.

In its Final Rule and Interpretive Guidance, the FSOC proposed a number of sample metrics to assess liquidity and maturity mismatch. See 77 Fed. Reg. at 21,660. These metrics help determine a nonbank financial company's vulnerability to financial distress. For instance, "[s]hort-term debt as a percentage of total debt and as a percentage of total assets . . . indicates a nonbank financial company's reliance on short-term debt markets." Id. In addition, the FSOC acknowledged that "[a]sset-liability duration and gap analysis . . . indicate[s] how well a nonbank financial company is matching the re-pricing and maturity of the nonbank financial company's assets and liabilities." Id.

The FSOC, however, failed to apply its own metrics in assessing MetLife. It glossed over the fact that MetLife's short-term debt is only 0.27 percent of its assets. See Final Basis at 286. It did not seriously engage in asset-liability duration and gap analysis.

Going a step further, a proper analysis of maturity mismatch should consider the likelihood that maturity mismatch would pose a systemic threat to the financial system. Even if there are

differences in the maturities of a company's assets and liabilities, such a risk can be mitigated by the liquidity of the company's assets. Thus, the FSOC proposed to consider such metrics as liquid asset ratios and the ratio of unencumbered and highly liquid assets to the net cash outflows and callable debt. See 77 Fed. Reg. at 21,660. To the contrary, analyzing MetLife, the FSOC simply glossed over the fact that "MetLife has a substantial portfolio of highly liquid assets." See Final Basis at 17. Not only did the FSOC fail to measure the degree of MetLife's maturity mismatch, but it also failed to measure the actual risk that MetLife's maturity mismatch poses to the financial system.

To be sure, the sample metrics listed in the Final Rule and Interpretive Guidance "are representative, not exhaustive, and may not apply to all nonbank financial companies under evaluation." 77 Fed. Reg. at 21,658. In this case, however, the sample metrics, such as asset-liability duration and gap analysis, were entirely applicable, as MetLife's "asset-liability profile differs fundamentally from the typical financial intermediary profile described in the Interpretive Guidance." Final Basis at 284. Still, the FSOC refused to apply its own sample metrics to MetLife.

C. The FSOC Refuses to Apply the Well-Established Principle That Collateral Is a Valid Hedge Against Risk

The FSOC in its Metlife decision heavily focused on maturity mismatch and liquidity risk stemming from MetLife's securities lending program. That focus fails to take account of the fact that the program's transactions are heavily collateralized—as the FSOC itself admitted.

The FSOC recognized that "[a]pproximately 88 percent of the securities lent by MetLife are U.S. government and agency securities, whose liquidity helps to protect counterparties." Final Basis at 156. And the FSOC even noted that "MetLife invested \$6.6 billion of the cash collateral in U.S. Treasury and agency securities, which would be sold to satisfy any cash requirements due to the termination of securities lending agreements." *Id.* at 157. However, this did not prevent the FSOC from speculating that MetLife "could transmit material financial distress to other market participants as a result of a rapid liquidation of invested collateral to produce the necessary liquidity to return

cash collateral to its securities lending counterparties.” *Id.* Thus, in its final determination, the FSOC failed to consider MetLife’s access to liquid assets.

That is reasoning that has no stopping point and cannot be squared with general principles of risk regulation. Under the FSOC’s analysis, material financial distress at any large, interconnected financial company with a securities lending program of any size would pose a threat to U.S. financial stability, regardless of the liquidity of the company’s assets.

E. Some Financial Firms, Such As Insurance Companies Are Less Interconnected With One Another and With the Financial System

Banks are institutionally interconnected. They extend loans to one another through the interbank lending market and transact in over-the-counter derivatives. Therefore, the financial system is susceptible to systemic risk arising from banks. Financial distress at a large bank can impact the financial system at large and pose a threat to U.S. financial stability.

In particular, banks routinely encounter counterparty risk that stems from their trading partners, including other banks. Counterparty risk comes in various forms, such as default risk, replacement risk, and settlement risk. Moreover, the magnitude of counterparty risk increases with the degree of interconnectedness of the trading partners. During the 2008 financial crisis, “increased counterparty risk contributed to” the unfolding of the financial market turmoil. John B. Taylor & John C. Williams, *A Black Swan in the Money Market*, 1 AM. ECON. J.: MACROECONOMICS 58, 58 (2009).

In contrast, insurance companies lack the banking system’s interconnectedness in two distinct ways. First, insurance companies are less interconnected with one another than banks are. There exists no “insurance system” comparable to the banking system. Insurance companies are not directly linked to one another through their balance sheets. While insurance companies cede some of their risks through reinsurance agreements, reinsurers only take up portions of the

primary risks of insurers, acting as a backstop. Second, insurance companies are not as interconnected with the rest of the financial system as banks are. On the one hand, insurance companies act as financial intermediaries and invest in financial markets. However, “the degree to which insurance companies are interconnected with other financial institutions is generally less significant than the interconnection among banks and brokerage firms.” National Association of Insurance Commissioners, Capital Markets Bureau, *U.S. Insurance Industry’s Investment Exposure to the Financial Sector*, available at http://www.naic.org/capital_markets_archive/130405.htm (last visited May 18, 2015). Insurance companies, for instance, may participate in securities lending as a low-risk investment strategy, but they do not participate in interbank lending. See National Association of Insurance Commissioners, Capital Markets Bureau, *Securities Lending in the Insurance Industry*, http://www.naic.org/capital_markets_archive/110708.htm (last visited May 18, 2015).

Because insurance companies are less interconnected with one another and with the financial system than banks, their exposure to the financial system is more limited. Moreover, insurance companies do not impose the same level of counterparty risk on the financial system as banks do. Indeed, empirical studies point toward lack of “any evidence in favor of contagion of failures in insurance.” WHEN INSURERS GO BUST at 92. In sum, insurance companies are less interconnected, and thus less likely to pose a threat to U.S. financial stability than banks.

III. Cost-Benefit Analysis Allows for a More Transparent and Prudential Regulation of the Insurance Industry.

One sensible and often-followed approach to risk regulation seeks to measure whether taking a particular precaution is worth the cost. Under cost-benefit analysis, “all potential gains and losses from a proposal are identified, converted into monetary units, and compared on the basis of decision rules to determine if the proposal is desirable from society’s standpoint.” Tevfik F. Nas, COST-BENEFIT ANALYSIS: THEORY AND APPLICATION 1-2 (1996). Thus, the analyst “must

painstakingly identify all relevant costs and benefits and measure their true resource values under alternative policy and economic environments.” *Id.* at 5-6. By applying cost-benefit analysis, the FSOC could have avoided the problems in its analyses. To the contrary, the FSOC rejected cost-benefit analysis as “not required . . . in connection with this rulemaking.” 77 Fed. Reg. at 21,651.

In 1993, President Clinton issued Executive Order 12,866, which established guiding principles for regulation by federal agencies. See Exec. Order No. 12,866, 3 C.F.R. § 638 (1994). The Order noted that the “American people deserve a regulatory system that . . . improves the performance of the economy without imposing unacceptable or unreasonable costs on society.” *Id.* Thus, it mandated federal agencies to “assess all costs and benefits of available regulatory alternatives, including the alternative of not regulating.” *Id.* at § 1(a). Furthermore, federal agencies must “consider, to the extent reasonable, the degree and nature of the risks posed by various substances or activities within [their] jurisdiction.” *Id.* at § 1(b)(4).

Within the context of financial regulation, cost-benefit analysis is based on the idea that “regulation is desirable only if the costs of regulation are smaller than the benefits from mitigating a market failure.” *WHEN INSURERS GO BUST* at 74. For instance, under cost-benefit analysis, the FSOC would have considered whether the marginal benefits of federal supervision of MetLife outweigh its marginal costs. In particular, the higher the level of existing regulatory scrutiny, the lower the marginal benefits of additional regulation will be.

As another example, under cost-benefit analysis, the FSOC would have considered the likelihood or probability of MetLife’s failure. Given that the FSOC aims to “address any potential risks to U.S. financial stability posed by” nonbank financial companies, 77 Fed. Reg. at 21,637 (emphasis added), the marginal benefits of regulating nonbank financial companies should be discounted by the probability of such risks. Thus, the FSOC would have relied less on such analyses as “run-on-the-bank” scenario, which may pose a great threat to U.S. financial stability but is not likely to materialize.

Cost-benefit analysis also places a premium on transparency: the methodology is employed right out in the open. Indeed, cost-benefit analysis “can be understood as . . . a method for ensuring that the consequences of regulation are not shrouded in mystery but are instead made available for public inspection and review.” Cass R. Sunstein, *The Cost-Benefit State* 4, *The Univ. of Chi. Law & Economics*, Olin Working Paper No. 39 (May 1996).

Therefore, although cost-benefit analysis may not be the only rational approach in every situation, it is a sound set of principles that in this case would have helped the FSOC to avoid the problems in its analyses identified above. And if the FSOC publicly followed the well-established cost-benefit methodology, companies would be better able to understand and respond to the FSOC’s determination process, and the public would be better able to scrutinize the FSOC’s determination standards. The FSOC would have created a genuine justification for its actions that the public could review and critique or accept. Instead, the FSOC’s insistence that “a determination decision can[not] be reduced to a formula,” 77 Fed. Reg. at 21,642, resulted in a failure of risk regulation and a failure of transparency.

CONCLUSION

The FSOC’s analysis thus far as failed to consider important characteristics of the company under consideration for SIFI as well as the nature of the industry (insurance, for example) in which the company operates. Its analysis overemphasizes the size and purported interconnectedness of the firm under consideration to the exclusion of relevant factors, such as substitutability, liquidity risk and maturity mismatch, and existing regulatory scrutiny. The FSOC’s analysis also has relied on speculative scenarios that failed to consider important aspects of insurance companies, which are less interconnected and better positioned to manage maturity mismatch and liquidity problems than banks.

Testimony of

Hal S. Scott

Nomura Professor and Director of the Program on International Financial Systems,

Harvard Law School;

Director of the Committee on Capital Markets Regulation

Before the

Subcommittee on Oversight and Investigations

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Thank you, Chairman Duffy, Ranking Member Green, and members of the Subcommittee for permitting me to testify before you today at this hearing on “Oversight of the Financial Stability Oversight Council (“FSOC”): Due Process and Transparency in Non-Bank SIFI Designations.” I am testifying in my own capacity and do not purport to represent the views of any organizations with which I am affiliated, although some of my testimony is consistent with the publicly stated views of the Committee on Capital Markets Regulation (“Committee”). My testimony will focus on three distinct points. First, the FSOC is an inadequate substitute for real reform of the regulatory structure, which is badly needed. Second, FSOC’s principle role, to designate non-banks as systemically important financial institutions (“SIFIs”), is ill-advised. Third, FSOC actions are subject to the Administrative Procedure Act (“APA”) and the non-bank SIFI designation process should accordingly be revised to provide the public with the

opportunity for notice and comment, including a cost-benefit analysis, and to provide the non-bank designee with full transparency of decision-making.

The U.S. financial regulatory framework is highly fragmented and ineffective, as multiple agencies have responsibilities for the same or closely related entities and markets. The fragmentation of regulators is not the product of careful design. It has evolved by layers of accretion since the Civil War. The 2008 crisis demonstrated that this dysfunctional system comes at a very high cost. In response to the crisis, the Committee issued a report entitled “The Global Financial Crisis: A Plan for Regulatory Reform”¹ with 57 specific recommendations to reform our financial system. In particular, we supported regulatory reorganization so that there would be sensible, efficient, non-duplicative regulation of financial firms.

Although other leading financial centers, including the United Kingdom and the European Union, reorganized and consolidated their regulatory structure in response to recent financial crises, the U.S. has not.² As a result, interagency jurisdictional overlap and conflicts continue to result in inconsistent rulemakings and delays or inaction on critical matters, including the implementation of Dodd-Frank. For example, the SEC and CFTC’s implementation of Dodd-Frank’s Title VII requirements for cross-border OTC derivatives would apply distinctly different registration, clearing and margin requirements to the same entities.³ The Volcker rule⁴ is a notable example of conflict

¹ Comm. On Capital Mkts. Reg., *The Global Financial Crisis: A Plan for Regulatory Reform* (May 26, 2009), <http://www.sec.gov/rules/final/2014/34-72472.pdf>; and <http://www.cftc.gov/LawRegulation/FederalRegister/FinalRules/2013-17958>

² See generally Sabrina Pellerin, John R. Walter, and Patricia Wescott, *The Consolidation of Financial Regulation: Pros, Cons, and Implications for the United States*, FRB Richmond Economic Quarterly, vol. 95, no. 2 (2009), <http://ssrn.com/abstract=2188499>.

³ 12 C.F.R. §44, 12 C.F.R. §248, 12 C.F.R. §351, 17 C.F.R. §255, and 17 C.F.R. §75.

among regulators, as disagreements between the SEC and banking regulators reportedly contributed to the more than one-year delay in its finalization.⁵ Additionally, it is difficult for agencies with related responsibilities to share data, as doing so requires strong protections for confidentiality of information obtained by a particular agency for supervisory purposes.⁶ Limits in data sharing increase the possibility that regulators will fail to identify risks that exist across institutions and markets.

In addition to retaining the fragmented structure, the Dodd-Frank Act created new regulatory agencies, including the FSOC,⁷ Bureau of Consumer Financial Protection,⁸ and Office of Financial Research,⁹ with authorities that overlap the existing agencies. As you know, the FSOC consists of 10 voting members: the Secretary of the Treasury (the Chair), and the heads of the CFTC, SEC, Federal Reserve, OCC, FDIC, CFPB, FHFA, NCUA, and an independent insurance expert appointed by the President.¹⁰ The Council meets at least quarterly¹¹ and its general purpose is to identify and respond to risks to the stability of the U.S. financial system.¹²

The FSOC has several authorities that purport to address the fragmented nature of the regulatory structure, but its real ability to do so is severely limited given the fact that many of its members are independent agencies not beholden to the commands of the Secretary of the Treasury.

⁵ See Scott Patterson, Volcker Rule Could Be Delayed – Again, W.S.J. (Feb. 27, 2013).

⁶ See, e.g., the Federal Reserve's regulations on Confidential Supervisory Information, 12 C.F.R. §261.20.

⁷ 12 U.S.C. §5321(a).

⁸ 12 U.S.C. §5491.

⁹ 12 U.S.C. §5342.

¹⁰ 12 U.S.C. §5321(b)(1)(A)-(J).

¹¹ 12 U.S.C. §5321(c)(1).

¹² 12 U.S.C. §5322(a).

First, the FSOC has authority to mediate disagreements between regulators over rulemakings or overlapping supervisory authorities¹³ and issue related recommendations, but this requires an affirmative vote of 2/3 of the members of FSOC.¹⁴ Even if FSOC is able to make recommendations, it has no mechanism for enforcing them. Second, the FSOC can issue recommendations that another agency issue a specific rulemaking, if the FSOC determines that such a rulemaking is necessary to mitigate risk to the financial system.¹⁵ This only requires a simple majority of the FSOC members.¹⁶ However, the FSOC cannot require that the agency actually implement these rulemakings. In November 2012, the FSOC exercised this authority by proposing recommendations for money market mutual fund reforms to the SEC.¹⁷ In its recommendation, the FSOC argued that capital requirements would mitigate systemic risk posed by the funds, but the SEC ultimately decided not to implement capital requirements for money market funds.¹⁸

The FSOC non-bank SIFI designation process itself has also served to exacerbate conflict among regulators. If 2/3 of the members of FSOC determine that a non-bank is systemically important, then they may designate that non-bank as a SIFI providing the Federal Reserve with supervisory and regulatory authority over that non-bank.¹⁹ Although the primary regulator of that entity would still retain its jurisdictional authority, it must now share those responsibilities with the Federal Reserve. This source of conflict recently surfaced in connection to the potential designation of large asset managers as

¹³ See 12 U.S.C. §5329.

¹⁴ Id.

¹⁵ 12 U.S.C. §5322(a)(2)(K).

¹⁶ 12 U.S.C. §5321(f).

¹⁷ Press Release, Financial Stability Oversight Council Releases Proposed Recommendations for Money Market Mutual Fund Reform (Nov. 13, 2012), <http://www.treasury.gov/press-center/press-releases/Pages/tg1764.aspx>.

¹⁸ 17 C.F.R. §§230, 239, 270, 274, and 279.

¹⁹ 12 U.S.C. §5323.

SIFIs. Chair Mary Jo White²⁰ and Commissioners Aguilar and Gallagher²¹ have expressed skepticism that non-bank SIFI designation is appropriate for asset managers, believing that the SEC is best positioned to identify and address any risks posed by large asset managers.²² This is reasonable considering that the SEC is the only agency on the FSOC with regulatory authority, and expertise, in this field.²³

Indeed, it is worth noting that publicly held equities and debt in the United States capital market total approximately \$57 trillion, as compared to just \$15.9 trillion in banking assets.²⁴ But the SEC, which has jurisdiction over these markets, only gets one vote on the FSOC.

The flaws with the rationale for non-bank SIFI designation go far beyond regulatory conflict or a lack of relevant subject matter expertise. Indeed, the fundamental principle underlying these designations is fatally flawed. Designating non-banks as systemically important and then subjecting these institutions to more stringent regulation simply does not reduce systemic risk. Moreover, singling out certain firms for SIFI designation potentially increases moral hazard, and could introduce competitive

²⁰ See https://www.ici.org/viewpoints/view_14_gmm_white; and https://www.ici.org/viewpoints/view_15_gmm_white

²¹ See SEC Commissioner Daniel M. Gallagher, Bank Regulators at the Gates: The Misguided Quest for Prudential Regulation of Asset Managers: Remarks at the 2015 Virginia Law and Business Review Symposium (April 10, 2015), <http://www.sec.gov/news/speech/041015-spch-cdmg.html>; and Mark Schoeff Jr., SEC commissioners push back against systemic designation for mutual funds, Investment News (April 3, 2014), <http://www.investmentnews.com/article/20140403/FREE/140409958/sec-commissioners-push-back-against-systemic-designation-for-mutual>.

²² See generally Andrew Ackerman and Ryan Tracy, SEC Fights Turf War Over Asset Managers, W.S.J. (Jan. 28, 2014).

²³ See generally Commissioner Michael S. Piwowar, Remarks at AEI Conference on Financial Stability (July 15, 2014), <http://www.sec.gov/News/Speech/Detail/Speech/1370542309109>.

²⁴ International Monetary Fund, Statistical Appendix to the Global Financial Stability Report (April 2015), <https://www.imf.org/External/Pubs/FT/GFSR/2015/01/pdf/statapp.pdf>.

distortions into the marketplace if these designees enjoy reduced funding costs, a subject of some debate.²⁵

Designating and then regulating large non-banks as SIFIs does not reduce systemic risk, because systemic risk is not confined to or concentrated in a few discrete entities. Regulating systemic risk requires a focus on systemically risky activities and products. Shoehorning a few large insurance companies or asset managers into a regulatory schema designed for the banking industry accomplishes little with potential high cost²⁶ and is unsupported by any empirical data.

In the 2008 financial crisis, no large financial firms failed as a direct result of their exposures to Lehman Brothers.²⁷ Analyses also show that direct losses due to the failure of AIG would also not have caused the bankruptcy of its large counterparties.²⁸ Instead, in 2008, systemic risk existed due to contagion, which is an indiscriminate run by short-term creditors across the entire financial system. Thus, there is no evidence for the principle underlying SIFI designations--that large financial institutions are so interconnected to each other that the bankruptcy of one will cause the bankruptcy of others.

Furthermore, as the Committee has previously commented, the activities of certain types of financial institutions, including traditional insurance companies, do not

²⁵See generally, GAO Report, Large Bank Holding Companies: Expectations of Government Support, (July 2014), <http://www.gao.gov/assets/670/665162.pdf>.

²⁶Letter from Comm. on Capital Mkts. Reg. to the Financial Stability Oversight Council (March 16, 2015), http://capmktreg.org/app/uploads/2015/03/2015_03_16_FSOC_Notice_on_Asset_Management_Products_Activities.pdf.

²⁷See Hal S. Scott, Interconnectedness and Contagion - Financial Panics and the Crisis of 2008 (June 26, 2014), <http://ssrn.com/abstract=2178475> [hereinafter Interconnectedness and Contagion] Comm. on Capital Mkts. Reg., What to Do About Contagion? A Call by the Committee on Capital Markets Regulation for a Public Debate (Sept. 3, 2014), <http://capmktreg.org/app/uploads/2014/09/2014-09-03-WDAC.pdf>.

²⁸See Interconnectedness and Contagion, supra note [27]; see also Peter J. Wallison, On regulating and resolving institutions considered 'too big to fail' (May 6, 2009), <https://www.aei.org/publication/on-regulating-and-resolving-institutions-considered-too-big-to-fail/>.

generally pose systemic risk.²⁹ During the 2008 financial crisis, no insurer was in danger of failing due to traditional insurance activities. The risk posed by AIG was not from its traditional life and property insurance activities. Rather, AIG's large losses and liquidity crisis were due to the credit protection that AIG Financial Products sold on multi-sector collateralized debt obligations that were exposed to U.S. subprime mortgages and reinvestment of cash collateral in mortgage backed securities by AIG's securities-lending subsidiary.³⁰ Engaging in these activities on a significant scale should be subject to regulation; it does not require SIFI designation.

One problem with the activities approach in the insurance sector is that there is currently no federal regulator for large U.S. insurance companies to identify and control non-traditional activities—state insurance company regulation may not be sufficient. I would therefore recommend serious consideration of an optional federal charter program for insurance companies, and possibly making such a charter mandatory for the largest companies.³¹ It is important to note recent efforts by the International Association of Insurance Supervisors to identify “non-traditional” insurance activities.³² Once defined, this would facilitate efforts by state or federal insurance supervisors to prevent insurers from engaging in these non-traditional activities on any dangerous scale. Further, if

²⁹ Letter from Comm. on Capital Mkts. Reg., to Acting Chairman of the Financial Stability Oversight Committee, the Hon. Neal S. Wolin (Feb. 15, 2013), http://capmksreg.org/app/uploads/2013/02/FSOC.floating.NAV_comment.ltr_.pdf.

³⁰ Frank M. Keane, Securities Loans Collateralized by Cash: Reinvestment Risk, Run Risk, and Incentive Issues, Federal Reserve Bank of New York Current Issues in Economics and Finance, vol. 19, no.3 (2013), http://www.newyorkfed.org/research/current_issues/ci19-3.pdf.

³¹ Regulatory Modernization: Perspectives on Insurance: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs, 111th Cong. (2009) (statement of Hal S. Scott, Nomura Professor of International Financial Systems, and Director, Committee on Capital Markets Regulation, Harvard Law School), <http://capmksreg.org/news/hal-s-scott-testifies-on-regulatory-modernization-as-it-relates-to-the-insurance-industry/>.

³² Comm. on Capital Mkts. Reg. Response to Public Consultation Document of International Association of Insurance Supervisors (July 31, 2012), http://capmksreg.org/app/uploads/2014/10/2012.07.31_IAIS_comment_letter.pdf.

FSOC believes that a federal regulator for insurance companies is necessary to regulate such activities, then FSOC should itself recommend the implementation of a federal charter program for insurance companies. SIFI designation is not the answer to this problem.

The recent designation of MetLife (a member of the Committee) as a non-bank SIFI is a trenchant example of the lack of empirical justification for non-bank SIFI designations.³³ The rule for FSOC non-bank SIFI designations sets forth two channels by which a non-bank may pose systemic risk.³⁴ The first is through interconnectedness, referred to by FSOC as the “exposure” channel, and the second is the “liquidation channel,” whereby the failure of a non-bank would drive down asset prices and thus weaken other firms holding the same or similar assets. In response to the first, MetLife has demonstrated that in the event of its failure, no other large firms would incur significant losses.³⁵ For example, the losses to the largest U.S. banks would be less than 2% of their capital. In response to the second, MetLife demonstrated that even if all of its life insurance policyholders ran, an unprecedented occurrence and one which could be blocked by the state powers of insurers to suspend massive withdrawals, then the resulting price impact on its assets and similar assets held by other financial institutions would not disrupt financial markets.³⁶

³³ Basis for the Financial Stability Oversight Council’s Final Determination Regarding MetLife, Inc. (Dec. 18, 2014), <http://www.treasury.gov/initiatives/fsoc/designations/Documents/MetLife%20Public%20Basis.pdf>.

³⁴ 12 C.F.R. §1310.

³⁵ See MetLife, Inc.’s (Plaintiff) Cross Motion For Summary Judgment, No. 1:15-cv-45 (RMC) (D.D.C. June 16, 2015), https://www.metlife.com/assets/cao/sifiupdate/Motion_for_Summary_Judgment_As_Filed.pdf [hereinafter MetLife Cross-Motion].

³⁶ Id.

Fortunately, the FSOC's ability to make non-bank SIFI designations is subject to an important APA limitation. Indeed, MetLife is challenging its non-bank SIFI designation on the basis that the FSOC's determination that the failure of MetLife would pose systemic risk fails to comply with the arbitrary and capriciousness standard of the APA and thus should be overturned by the courts.³⁷ The APA³⁸ subjects all agency decision making to the arbitrary and capricious clause of APA § 706(2)(a).

The Supreme Court has interpreted this provision of the APA to require that agencies "examine the relevant data and articulate a satisfactory explanation for its action[,] including a rational connection between the facts found and the choice made."³⁹ An agency action is arbitrary and capricious if the agency "entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise."⁴⁰ The D.C. Circuit has interpreted this to mean that agencies must consider evidence that contradicts their determination and to explain why they rejected such evidence.⁴¹ Thus, the FSOC's discretion to issue non-bank SIFI designations is not limitless.

The non-bank SIFI designation *process* is also in need of reform. This is because an individual non-bank SIFI determination is not subject to the APA's requirements for public notice and comment, since it does not constitute a rulemaking.⁴² As a result, the general public, including potential future designees, receive very little information

³⁷ *Id.*

³⁸ 5 U.S.C. §500 *et seq.*

³⁹ *Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983)

⁴⁰ *Id.*

⁴¹ *See Int'l Union, United Mine Workers of Am. v. Mine Safety & Health Admin.*, 626 F.3d 84, 93-94 (D.C. Cir. 2010); *see also Swiss Airlines Co. v. Transportation Sec. Admin.*, 650 F.3d 752, 759-60 (D.C. Cir. 2011)

⁴² *See* 5 U.S.C. §553.

regarding the basis for the FSOC's designations, despite the significant market impact of these designations. Indeed, the designations of Prudential, AIG, GE Capital and MetLife were each accompanied solely by a ten-to-forty page public release that lacked any meaningful empirical data supporting the designation.⁴³ By excluding the public from involvement in the designation process, the FSOC is unnecessarily limiting the opportunity to receive data and input from outside experts.

The FSOC also does not conduct a cost-benefit analysis when making non-bank SIFI designations, as it is not statutorily required to do so.⁴⁴ This is despite President Obama stressing in a 2011 Executive Order that cost-benefit analyses are a crucial part of the regulatory process and recent remarks by Secretary of the Treasury Jack Lew to the same effect.⁴⁵ Indeed, I strongly believe that cost-benefit analyses are an important tool that regulators should use to enhance the economic efficiency of their rulemakings. Such economic analyses are particularly relevant to non-bank SIFI designations, as the FSOC should be required to analyze the benefit of preventing the failure of a potential SIFI (will other firms actually fail if it does?) against the cost to the financial system from such a

⁴³ These releases by the Financial Stability Oversight Council of its designations thus far are available at: <http://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx>.

⁴⁴ See Financial Stability Oversight Council (Defendant), Memorandum in Support of Defendant's Motion to Dismiss Or, In the Alternative, For Summary Judgement, No. 15-45 (RMC) (D.D.C. May 11, 2015).

⁴⁵ President Obama, Executive Order 13579--Regulation and Independent Regulatory Agencies, <https://www.whitehouse.gov/the-press-office/2011/07/11/executive-order-13579-regulation-and-independent-regulatory-agencies>:

("Section 1. Policy. (a) Wise regulatory decisions depend on public participation and on careful analysis of the likely consequences of regulation. Such decisions are informed and improved by allowing interested members of the public to have a meaningful opportunity to participate in rulemaking. To the extent permitted by law, such decisions should be made only after consideration of their costs and benefits (both quantitative and qualitative)."); and Ira Hammerman, Lew: Administration Opposed to Any Corrections that Undermine Financial Reform (Nov. 11, 2015), <http://www.sifma.org/blog/lew-administration-opposed-corrections-undermine-financial-reform/> ("Lew stressed the importance of financial reforms made following the damage of the financial crisis to the U.S. economy. "I have worked on regulatory issues from a number of different perspectives and I very much believe that when you look at regulation, you have to look at the costs and the benefits. And I think that the benefits of financial reforms are just enormous," he said.").

designation. One difficulty in estimating costs or benefits is that we do not know at the point of designation how the Fed will actually regulate a given SIFI, e.g. how will the capital requirements of SIFI insurance companies be determined. Without knowing the consequences of designation it is almost impossible to make a rational designation choice.

I believe that the FSOC should of its own volition provide the public with the opportunity for notice and comment in the non-bank SIFI designation process and that this should include a cost benefit analysis. If the FSOC does not do so, then Congress should revise Dodd-Frank so that the FSOC has these statutory obligations.

The designation process is also very opaque from the perspective of the potential designee.⁴⁶ The designee does not receive an opportunity to present its position to the FSOC until the FSOC is nearly complete with its process.⁴⁷ The FSOC also does not provide the designee with the opportunity to review the record upon which its decision is based or with the details of any prior designations that could assist the potential designee in efforts to revise its business in order to avoid designation.⁴⁸

I believe that the FSOC should involve potential designees in its process at the very start and should provide the designee with complete transparency into the basis for any potential designation. If the FSOC does not do so on its own accord, then I recommend that Congress revise Dodd-Frank so that the FSOC is required to do so.

In conclusion, I believe that the FSOC is an inadequate substitute for real reform of our fragmented regulatory structure and that FSOC's primary role, to designate non-banks as SIFIs would not reduce systemic risk and threatens to introduce competitive

⁴⁶ See e.g., MetLife Cross-Motion, *supra* note [35].

⁴⁷ See e.g., *id.*

⁴⁸ See e.g., *id.*

distortions and increase moral hazard. Finally, the non-bank SIFI designation process should be revised to provide the public with the opportunity for notice and comment, including a cost-benefit analysis, and to provide the non-bank designee with full transparency of decision-making.

Thank you and I look forward to your questions.

**“Oversight of the Financial Stability Oversight Council:
Due Process and Transparency in Non-Bank SIFI Designations”**

ADAM J. WHITE¹

Testimony before the Subcommittee on Oversight and Investigations,
Committee on Financial Services,
United States House of Representatives

November 19, 2015

Chairman Duffy, Ranking Member Green, and other members of the Subcommittee, thank you for inviting me to testify today on a matter of such fundamental importance to the country: its free and fair markets, and its principles of constitutional government. The Financial Stability Oversight Council poses significant challenges to both.

When President Obama signed the Dodd-Frank Act into law five years ago,² he said that “our financial system only works—our market is only free—when there are clear rules and basic safeguards that prevent abuse, that check excess, that ensure that it is more profitable to play by the rules than to game the system.”³ I agree wholeheartedly with his sentiment—both as it applies to private actors, and as it applies to government officials who regulate them. But Dodd-Frank’s creation

¹ Visiting Fellow—Hoover Institution, Washington, D.C. The views expressed in this testimony are mine alone, and are not offered on behalf of the Hoover Institution or any other organization.

² Pub. L. No. 111-203, 124 Stat. 1376 (2010).

³ “Remarks by the President at Signing of Dodd-Frank Wall Street Reform and Consumer Protection Act” (July 21, 2010), at <https://www.whitehouse.gov/the-press-office/remarks-president-signing-dodd-frank-wall-street-reform-and-consumer-protection-act>.

of the Financial Stability Oversight Council (FSOC) does not achieve those aims. If anything, it undermines them.

My prepared statement will offer three basic points: *First*, in structuring the FSOC, Dodd-Frank undermined constitutional governance by delegating overbroad powers to the FSOC while simultaneously removing or weakening key checks and balances that would guide and limit the exercise of those powers. *Second*, the FSOC's operations thus far confirm the dangers inherent in that structure. And *third*, in evaluating those problems, it is important to keep in mind that the FSOC's affect more than just the financial institutions regulated by the FSOC; they affect other market actors, and the public at large, who are denied a full and fair opportunity to participate in this momentous regulatory framework.

I. In creating the FSOC, Dodd-Frank delegated immense power to regulators but weakened crucial checks and balances that would guide and limit their use of that power.

The character of any regulatory agency is defined first and foremost by two fundamental characteristics: the amount of power that Congress delegates to the agency, and the agency's degree of structural "independence" or "insulation" from oversight by the President, Congress, and the courts. Each of these considerations is important in and of itself—a statute may be unconstitutional if it delegates too much power to an agency,⁴ or if it gives the agency too much structural

⁴ See *Whitman v. Am. Trucking Ass'ns*, 531 U.S. 457, 472 (2001) (explaining constitutional requirement that Congress specify an "intelligible principle" to guide and limit agency discretion); see also *Util. Air Reg. Group v. EPA*, 134 S. Ct. 2427 (2014) (rejecting an agency's interpretation of statute that would have given the

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independence.⁵ But even more important is the way that these two characteristics interact with one another: as Congress delegates broader powers to an agency or official, it becomes all the more important that the agency be subjected to the checks and balances of congressional, presidential, and judicial oversight.⁶

Unfortunately, Dodd-Frank's Title I accomplished precisely the opposite. It vested the newly created FSOC with effectively open-ended power, while *weakening* checks and balances instead of increasing them.⁷

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agency effectively unlimited discretion); John Hart Ely, *Democracy and Distrust* 132 (1980) (explaining that the nondelegation doctrine preserves the "accountability that is crucial to the intelligible functioning of a democratic republic.").

⁵ See, e.g., *Free Enter. Fund v. PCAOB*, 130 S. Ct. 3138 (2010) (holding unconstitutional a provision of the Sarbanes-Oxley Act that attempted to give the new Public Company Accounting Oversight Board a double-layer of structural independence from presidential accountability).

⁶ See, e.g., *Morrison v. Olson*, 487 U.S. 654, 691 (1988) (holding that the Independent Counsel was not unconstitutional because, *inter alia*, the office had only "limited jurisdiction and tenure and lack[ed] policymaking or significant administrative authority"); see also *Free Enter. Fund*, 561 U.S. at 496 ("This novel structure does not merely add to the Board's independence, but transforms it."); *Ass'n of Am. R.R. v. Dep't of Transp.*, 721 F.3d 666, 673 (D.C. Cir. 2013) ("just because two structural features raise no constitutional concerns independently does not mean Congress may combine them in a single statute"), *rev'd on other grounds*, 136 S. Ct. 1225 (2015); *King v. Burwell*, 135 S. Ct. 2480, 2488–89 (2015) (refusing to grant any judicial deference to the agency's interpretation of the Affordable Care Act, because the issue at hand was of such immense political and economic significance the Congress could not be presumed to have delegated it to agency).

⁷ I was co-counsel to plaintiffs challenging the FSOC's constitutionality. But the merits of that claim were not reached by the court, which dismissed the claim for lack of standing. *State Nat'l Bank of Big Spring v. Lew*, 795 F.3d 48 (D.C. Cir. 2015). I remain of counsel to the community bank and other plaintiffs challenging the CFPB.

When Dodd-Frank empowered the FSOC to designate nonbank financial institutions as “systemically important” (*i.e.*, “SIFIs”), it did so in literally open-ended terms. Section 113(a)(1) of the Act sets two basic standards for determining whether a nonbank financial institution is a “SIFI,”⁸ and lists ten “considerations” that the FSOC “shall consider” in making those determinations.⁹ But the Act concludes that list with an item allowing the FSOC to base its decision on not just those considerations but also “*any other* risk related factors that the *Council deems appropriate*.”¹⁰ Thus, the statute is completely malleable—as demonstrated by the FSOC’s decision to unilaterally re-write the statute into a set of three “channels” and six “categories” of the FSOC’s own making.¹¹

Given the breadth of power delegated to the FSOC, the Constitution’s structural checks and balances against FSOC overreach were all the more important. But instead of fortifying those checks and balances, Dodd-Frank weakened them.

Most significantly, Dodd-Frank made the FSOC independent from Congress’s appropriations power, thus freeing the Council from full, meaningful congressional

⁸ Specifically, whether (1) “material financial distress at the U.S. nonbank financial company,” or (2) its “nature, scope, size, scale, concentration, interconnectedness, or mix of the activities,” “could pose a threat to the financial stability of the United States.” 12 U.S.C. § 5323(a)(1).

⁹ *Id.* § 5323(a)(2).

¹⁰ *Id.* §5323(a)(2)(K) (emphasis added).

¹¹ FSOC, Final Rule and Interpretive Guidance, *Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies*, 77 Fed. Reg. 21637, 21657–60 (2012).

oversight. In Federalist 58, James Madison wrote that Congress’s “power over the purse may, in fact, be regarded as the most complete and effectual weapon with which any constitution can arm the immediate representatives of the people, for obtaining a redress of every grievance, . . . for carrying into effect every just and salutary measure,” and for “reducing . . . all the overgrown prerogatives of the other branches of the government.”¹² But the FSOC does not face Congress’s power of the purse, because Dodd-Frank provides for all of FSOC’s expenses to be paid by the Office of Financial Research, which in turn is funded not by appropriations but by fees charged to the industry.¹³ (For this reason, it is crucial that Congress enact H.R. 3340 or similar legislation removing the FSOC’s automatic funding and requiring it to obtain appropriations from Congress.)

In addition to the FSOC’s independence from Congress, Dodd-Frank also purports to relax judicial review of the FSOC’s actions. Specifically, when a court hears an appeal of the FSOC’s nonbank SIFI designations, judicial review “shall be limited to whether the final determination made under this section was arbitrary

¹² See also, e.g., *Noel Canning v. NLRB*, 705 F.3d 490, (D.C. Cir. 2013) (“The Framers placed the power of the purse in the Congress in large part because the British experience taught that the appropriations power was a tool with which the legislature could resist ‘the overgrown prerogatives of the other branches of government.’”), *aff’d*, 134 S. Ct. 2550 (2014); S. Comm. on Gov’t Operations, 95th Cong. 1st Sess., 2 *Study on Federal Regulatory Agencies* 42 (1977) (“The appropriations process is the *most potent form* of congressional oversight, particularly with regard to the federal regulatory agencies.” (emphasis added)).

¹³ See Dodd-Frank §§ 118 & 155; 12 U.S.C. §§ 5328 & 5345 (e.g., “Funds obtained by, transferred to, or credited to the Financial Research Fund shall not be construed to be Government funds or appropriated moneys.”).

and capricious.”¹⁴ That provision, if read literally, might be construed by the FSOC or a judge as prohibiting the court from applying the other normal standards of judicial review of agency action set forth in the Administrative Procedure Act (APA) and applicable precedents, such as judicial review of whether the agency’s decision is “in accordance with law.”¹⁵

The APA was enacted to serve as nothing less than the “bill of rights” for all “Americans whose affairs are controlled or regulated” by “agencies of the Federal Government”—to “provide guaranties of due process in administrative procedure.”¹⁶ Congress should leave no doubt that those legal protections apply in full to the FSOC. (Accordingly I urge Congress to amend Dodd-Frank to delete Section 113(h)’s narrow provision for judicial review, and subject the FSOC to the general standards of review under the Administrative Procedure Act.)

In addition to removing or weakening Congress’s and the courts’ checks and balances against FSOC overreach, Dodd-Frank also structures the FSOC in such a way that lacks the normal “internal” checks and balances of independent regulatory commissions such as the Securities and Exchange Commission, Commodity Futures Trading Commission, and other expert regulatory agencies. Such agencies traditionally include a near-balance of members from both political parties, in order to ensure that the agency undertakes its work through deliberation, ultimately

¹⁴ Dodd-Frank § 113(h); 12 U.S.C. § 5323(h).

¹⁵ 5 U.S.C. § 706(2)(A).

¹⁶ ADMINISTRATIVE PROCEDURE ACT: LEGISLATIVE HISTORY, S. Doc. No. 79-248, 2d Sess., p. 298 (1946) (statement of APA sponsor Sen. McCarran).

producing not just an agency decision but also (when members disagree) published opinions from dissenting members.¹⁷ But the FSOC offers little or no such bipartisan deliberation, because it predominantly comprises agency heads appointed by the President and serving at his pleasure or, in the case of the FSOC's members from the SEC and other independent commissions, officers elevated to the commission's chair in the President's sole discretion.¹⁸

Indeed, Dodd-Frank gratuitously disregarded the expertise and deliberation available in the SEC, CFTC, and other independent member agencies, by seating only the commissions' respective chairmen as FSOC members, when it could have instead assigned FSOC membership to each respective independent commission acting as a commission—that is, to require, *e.g.*, the entire SEC to vote on FSOC matters rather than just the SEC's president-selected chairman.¹⁹

Having vested the FSOC with effectively open-ended powers, freed it from Congress's power of the purse, limited its exposure to judicial review, and

¹⁷ See, *e.g.*, *Humphrey's Ex'r v. U.S.*, 295 U.S. 602, 624 (1935) (describing a similar commission, the FTC, as being “neither political nor executive, but predominantly quasi judicial and quasi legislative . . . [I]ts members are called upon to exercise the trained judgment of a body of experts ‘appointed by law and informed by experience.’”).

¹⁸ See Dodd-Frank § 111(b); 12 U.S.C. § 5321(b). There are exceptions. The director of the Consumer Financial Protection Bureau, an FSOC member, serves a five-year term and keeps the office until his successor is successfully appointed. 12 U.S.C. § 5491(c). Likewise, the Chairman of the Federal Reserve, another FSOC member, serves a staggered four-year term on the Fed. *Id.* § 242.

¹⁹ Cf. *Free Enter. Fund*, 561 U.S. at 512–13 (“As a constitutional matter, we see no reason why a multimember body may not be the ‘Head’ of a ‘Department’ that it governs.” (brackets omitted)).

constructed it in a way that minimizes internal deliberations, scholars of the administrative state might assume that the FSOC would construe its statutory boundaries as broadly as possible and exercise its powers with little or no process due to affected parties.

They would assume correctly.

II. FSOC's operations confirm the dangers inherent in its structure.

The courts place great trust in checks and balances, especially Congress's power of the purse, to restrain agency excess.²⁰ The FSOC's record highlights the power of such checks and balances—because in their absence, the FSOC has expanded its power and minimized the rights afforded to private parties.

1. First and foremost, the FSOC's approach to designating nonbank SIFIs ignores even the limited requirements placed upon it by Title I of the Dodd-Frank Act. Specifically, the Act's Section 113(a)(1) empowers the FSOC to designate a US nonbank SIFI if the FSOC "determines that material financial distress" at that company *could* pose a threat to the financial stability of the United States."²¹ Indeed, in initially interpreting that provision the FSOC conceded that designating a SIFI on that basis would turn in part on whether the company is "more likely to be more vulnerable to financial distress."²² But in making its nonbank SIFI determinations, the FSOC subsequently declared that that it is *not* required to

²⁰ See, e.g., *Laird v. Tatum*, 408 U.S. 1, 15 (1972); *Pub. Citizen v. NHTSA*, 489 F.3d 1279, 1295 (D.C. Cir. 2007) (citing *Laird*).

²¹ 12 U.S.C. § 5323(a)(1) (emphasis added).

²² 77 Fed. Reg. at 21658.

consider the designated company’s actual vulnerability to material financial distress—or, as it argued in a recent court filing, the FSOC reads Dodd-Frank as leaving it entirely free “*not* to address the likelihood of the company’s distress” (emphasis in original).²³

The FSOC’s assumption of power to impose immense regulatory burdens on insurance companies not previously subject to such regulation, without having to show that such regulatory burdens are necessary to remediate an actual risk of public harm, is precisely the sort of regulatory approach that the Supreme Court rejects. In the *Benzene Case* (1980), the Court urged that if a statute were read to allow agencies to impose vast regulatory burdens without a showing of such “significant” risk to the public, then the statute “would make such a ‘sweeping delegation of legislative power’ that it might be unconstitutional” under the Court’s seminal nondelegation doctrine precedents. Thus, the Court held, a “construction of the statute that avoids this kind of open-ended grant should certainly be favored.”²⁴

More recently, when the Court this year struck down the EPA’s immensely burdensome mercury rule for failing to consider its disproportionate cost-benefit ratio, the Court stressed that “[o]ne would not say that it is even rational, never mind ‘appropriate,’ to impose billions of dollars in economic costs in return for a few

²³ See Reply Brief of FSOC at p. 39, in *MetLife, Inc. v. FSOC*, Case No. 1:15-cv-00045-RMC (D.D.C. filed Sept. 30, 2015) (redacted version).

²⁴ *Indus. Union Dep’t v. Am. Petroleum Inst. (Benzene Case)*, 448 U.S. 607, 646 (1980). Justice Rehnquist wrote separately but agreed on this point. *Id.* at 683.

dollars” in benefits.²⁵ The FSOC, construing its statute as allowing it to impose immense regulatory burdens without considering the actual real-world need for such regulations, simply ignores the Court’s repeated warnings against gratuitous regulation by self-aggrandizing regulators.²⁶

Ultimately, the law’s bedrock prohibition against “arbitrary and capricious” agency action requires the FSOC to “examine the relevant data and articulate a satisfactory explanation for its action including a ‘rational connection between the facts found and the choice made.’”²⁷ In failing to demonstrate precisely how its SIFI designations actually guard against the risk of systemic financial harm—indeed, in making such designations even over the vocal objections of the FSOC’s own member with specific subject-matter expertise²⁸—the FSOC fails to satisfy even that low standard of review.

2. The FSOC’s lack of checks and balances also is evidenced by the agency’s denial of basic due process rights to designated companies. In one SIFI

²⁵ *Michigan v. EPA*, 135 S. Ct. 2699, 2707 (2015).

²⁶ See generally C. Boyden Gray, *The Nondelegation Canon’s Neglected History and Underestimated Legacy*, 22 Geo. Mason L. Rev. 619 (2015).

²⁷ *Motor Vehicle Mfrs. Ass’n of U.S. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983).

²⁸ See FSOC SIFI Designation of Prudential, Inc., *Views of the Council’s Independent Member Having Insurance Expertise* (Sept. 19, 2013), at [http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/September 19 2013 Notational Vote.pdf](http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/September%2013%20Notational%20Vote.pdf); FSOC SIFI Designation of MetLife, Inc., *Views of the Council’s Independent Member Having Insurance Expertise* (Dec. 18, 2014), at [http://www.treasury.gov/initiatives/fsoc/designations/Documents/Dissenting and Minority Views.pdf](http://www.treasury.gov/initiatives/fsoc/designations/Documents/Dissenting%20and%20Minority%20Views.pdf).

designation proceeding currently on appeal in federal court, the FSOC refused to give the company access to the full record underlying the FSOC's decision.²⁹

The FSOC's reliance on secret evidence, for which the parties subject to its proceedings are denied a meaningful opportunity to respond, violates the fundamental right to due process protected by the Fifth Amendment and the Administrative Procedure Act. As the D.C. Circuit reiterated last year, in striking down the secretive action of another interagency body similar to FSOC, "due process requires, at the least, that an affected party be informed of the official action, be given access to the unclassified evidence on which the official actor relied and be afforded an opportunity to rebut that evidence."³⁰ While the courts recognize a limited exception for cases of *classified* information when nondisclosure is justified by "the Government's 'compelling' interest in national security,"³¹ that exception cannot be allowed to swallow the rule—namely, the rule that "disclosure of unclassified evidence is required by the Due Process Clause,"³² a "fundamental norm of due process clause jurisprudence."³³

²⁹ See Final Brief of MetLife, Inc., at p. 62–67, in *MetLife, Inc. v. FSOC*, Case No. 1:15-cv-00045-RMC (D.D.C. filed Sept. 30, 2015) (redacted version).

³⁰ *Ralls Corp. v. CFIUS*, 758 F.3d 296, 319 (D.C. Cir. 2014).

³¹ *Id.* at 318–19 (citing *Nat'l Council of Resistance of Iran v. Dep't of State*, 251 F.3d 192, 207 (D.C. Cir. 2001)).

³² *Id.* at 320.

³³ *Nat'l Council of Resistance of Iran*, 251 F.3d at 205 ("the fundamental norm of due process clause jurisprudence requires that before the government can constitutionally deprive a person of the protected liberty or property interest, it must afford him notice and hearing").

The FSOC's unconstitutional secrecy harms more than just the companies that it regulates. It also harms the public, which has the right and the need to know. As Justice Louis Brandeis noted, “[s]unlight is said to be the best of disinfectants; electric light the most efficient policeman.”³⁴ This is no less true in the public’s policing of the regulatory police themselves.

3. Due process concerns are also raised by allegations that the FSOC’s designations have been influenced heavily by the decisions of the international Financial Stability Board (FSB) to designate certain companies as “global” SIFIs (or “G-SIFIs”), which were then followed by the FSOC’s own designations.³⁵ While the courts recognize that regulators often approach a policy issue with preconceived notions of the public interest, such agency latitude is not unlimited: when an agency is shown clearly to have “an unalterably closed mind on matters critical to the disposition of the proceeding,” then it has violated the Due Process Clause.³⁶

To be clear, this is an *extremely* high bar for litigants to clear, and it has not yet been demonstrated with respect to the FSOC’s designations. But given that the FSOC’s proceedings have been extremely opaque in this respect—the agency has blocked inquiries into the influence of FSB’s G-SIFI designations on its own similar

³⁴ Louis D. Brandeis, *Other People’s Money* 92 (1914).

³⁵ See, e.g., Peter J. Wallison, AEI, *The Financial Stability Oversight Council and the Financial Stability Board: Issues in International Regulation*, Testimony Before the House Financial Services Subcommittee on Oversight and Investigations (Mar. 5, 2014), at <http://financialservices.house.gov/uploadedfiles/hhrg-113-ba09-wstate-pwallison-20140305.pdf>.

³⁶ See, e.g., *Air Trans. Ass’n of Am. v. Nat’l Mediation Bd.*, 663 F.3d 476, 487 (D.C. Cir. 2011).

SIFI designations³⁷—it is incumbent upon Congress to investigate whether the FSOC is approaching these momentous regulatory decisions with the open minds that constitutional due process requires.

4. Finally, the FSOC's lack of constitutional checks and balances is seen not just in the way that it asserts SIFI regulatory authority over nonbank financial companies, but also in the way that it ceases such regulatory authority—or, more specifically, in the way that it *refuses* to cease such regulatory authority.

The stated purpose of Dodd-Frank's Title I was to solve the problem of systemic risk, not simply to give federal regulators perpetual jurisdiction over regulated parties. Title I created the FSOC “to *end* ‘too big to fail,’”³⁸ not to provide a full-employment program for regulators.

Accordingly, so long as the FSOC exists to solve too-big-to-fail, the aim of every SIFI designation should be to identify and *remediate* situations presenting systemic risk—or, as the FSOC explained in its original rulemaking, to actually “*address* any potential risks to U.S. financial stability posed by these companies.”³⁹ But so far, the FSOC has not given SIFIs or the public a roadmap to the designated companies' eventual off-ramp from SIFI status.⁴⁰

³⁷ See MetLife Brief, *supra* note 29, at p. 11.

³⁸ Pub. L. No. 111-203, 124 Stat. 1376 (2010) (emphasis added).

³⁹ 77 Fed. Reg. at 21637 (emphasis added).

⁴⁰ See, e.g., Lucy Ren, *Insurers, Investment Managers Press for ‘Off-Ramp’ From SIFI Designation*, MARKETWATCH (July 8, 2015), at <http://www.marketwatch.com/story/insurers-investment-managers-press-for-off-ramp-from-sifi-designation-2015-07-08>; Evan Weinberger, *Fed Gives No Clues on SIFI Off-Ramp in GE Capital Rule*,

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There are strong institutional reasons for the FSOC not to provide such an off-ramp, to focus more on perpetual regulation than outright de-risking, thus keeping regulated parties (and the public) driving in regulatory circles instead of steering toward an off-ramp. In addition to maintaining strong regulatory power and leverage over the regulated parties, perpetual regulation also avoids giving any designated SIFI a clean bill of health, for which regulators would be held accountable in the event of subsequent financial turbulence. But the longer that FSOC-designated companies retain SIFI status instead of being un-SIFI'd, the more the public, and the markets, will be justified in seeing SIFI designations as the official formalization of too-big-to-fail status.

Ultimately, the maintenance of perpetual SIFI status, instead of the achievement of actual de-risking, threatens to perpetuate the very conditions that former Federal Reserve Chairman Bernanke warned against in early 2010:

[T]he existence of too-big-to-fail firms also imposes heavy costs on our financial system even in more placid times. Perhaps most important, if a firm is publicly perceived as too big, or interconnected, or systemically critical for the authorities to permit its failure, its creditors and counterparties have less incentive to evaluate the quality of the firm's business model, its management, and its risk-taking behavior. As a result, such firms face limited market discipline, allowing them to obtain funding on better terms than the quality or

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LAW360 (July 21, 2015), at <http://www.law360.com/articles/681551/fed-gives-no-clues-on-sifi-off-ramp-in-gc-capital-rule>.

riskiness of their business would merit and giving them incentives to take on excessive risks.⁴¹

If Title I created the FSOC to “end” too big to fail, then the FSOC should actually pursue that aim, and explain to the public how it intends to do so.

III. Dodd-Frank denies other market actors, and the public at large, the opportunity to participate fully and meaningfully in this momentous regulatory framework.

The foregoing discussion focuses primarily on the rights of companies facing the possibility of being designated nonbank SIFIs by the FSOC. But it would be a great mistake to presume that they are the *only* ones with interests at stake in the FSOC’s decisions. Rather, those decisions directly affect other markets actors, including a SIFI’s competitors, and the American people generally.

It has long been recognized that if the government sees a company as “too big to fail” then markets will treat that company as less risky—since the government is trusted to intercede in time of crisis—distorting market prices and disfavoring competitors without a similar governmental imprimatur. In 2011, for example, Moody’s estimated that for U.S. companies the “too big to fail” cost-of-capital advantage was 23 basis points before the financial crisis and 56 basis points thereafter, worth billions of dollars.⁴² Of course, many companies facing the

⁴¹ “Preserving a Central Role for Community Banking” (Mar. 20, 2010), at <http://www.federalreserve.gov/newsevents/speech/bernanke20100320a.htm>.

⁴² Zan Li et al., *Quantifying the Value of Implicit Government Guarantees for Large Financial Institutions* (2011), at <http://www.moodyanalytics.com/~media/Insight/Quantitative-Research/Credit-Valuation/2011/2011-14-01-Quantifying-the-Value-of-Implicit-Government-Guarantees-for-Large-Financial-Institutions-20110114.pdf>; see also Joseph Noss & Rhiannon Sowerbutts, Bank of England, *The Implicit*

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possibility of designation would find even such a cost-of-capital advantage to be insufficient consolation from the extra costs of new federal regulation. But some, especially those already subject to extensive federal regulation, might find the subsidy well worth the cost. In 2013, Connecticut's Insurance Commissioner told an international audience that SIFI designations are "really good" for the designated company, because it's thus "potentially too big to fail, so the government is not going to let this company go."⁴³ This might explain why the first three nonbank SIFIs' stock prices *increased* upon news of their FSOC designations.⁴⁴ It might also explain recent statements by A.I.G.'s chief executive, who indicated that "he found SIFI status less objectionable and thought A.I.G. could work with its Fed regulators."⁴⁵

As former Federal Reserve Chairman Bernanke observed in his aforementioned 2010 speech, "[h]aving institutions that are too big to fail also creates competitive inequities that may prevent our most productive and innovative

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Subsidy of Banks (May 2012), at http://www.bankofengland.co.uk/financialstability/Documents/fpc/fspapers/fs_paper15.pdf.

⁴³ Gavin Souter, *Stability, Higher Costs Seen in Systemic Designation for Insurers*, BUSINESS INS. (June 19, 2013), at <http://www.businessinsurance.com/article/20130619/NEWS04/130619774/stability-higher-costs-seen-in-systemic-designation-for-insurers>.

⁴⁴ Ian Katz & Zachary Tracer, *AIG, Prudential Named Systemically Important by Panel*, Bloomberg (June 4, 2013), at <http://www.bloomberg.com/news/articles/2013-06-03/u-s-regulators-vote-to-label-some-non-banks-systemically-risky>.

⁴⁵ Mary Williams Walsh, *A.I.G. Considers How to Act With SIFI Tag*, N.Y. TIMES (May 1, 2015), at <http://www.nytimes.com/2015/05/02/business/dealbook/aig-considers-how-to-act-with-sifi-tag.html>.

firms,” such as the community banks he was addressing, “from prospering.”⁴⁶ Given that FSOC’s SIFI designations might in some cases serve as a net *subsidy* rather than a net burden, those designations must be susceptible to judicial review by competitors and other affected companies. But Dodd-Frank does not provide for judicial review by other affected parties.⁴⁷ Congress should fix this as soon as possible, by amending the FSOC’s judicial review provision to expressly allow appeals of FSOC designations by other affected parties.

* * *

Ultimately, the FSOC’s faults were of Congress’s own making. The FSOC, like all agencies, is a “creature[] of Congress,” and thus had “literally . . . no power to act . . . unless and until Congress confer[red] power upon it.”⁴⁸ The fact that the Dodd-Frank Congress eagerly gave such power and structural independence to the FSOC is no answer, for a particular Congress, like a particular President, “might find advantages in tying [its] own hands.”⁴⁹ But just as the separation of powers does not depend on the views of individual Presidents,” nor does it depend on the views of individual Congresses.⁵⁰

⁴⁶ See note 41, *supra*.

⁴⁷ See Dodd-Frank § 113(h); 12 U.S.C. § 5323(h) (providing judicial review only for the designated nonbank financial company).

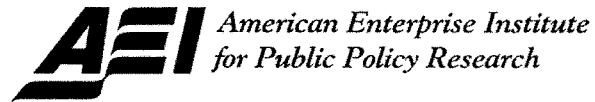
⁴⁸ *City of Arlington v. FCC*, 133 S. Ct. 1863, 1880 (2013) (Roberts, C.J., dissenting) (quoting *La. Pub. Serv. Comm’n v. FCC*, 476 U.S. 355, 374 (1986)).

⁴⁹ *Free Enter. Fund*, 561 U.S. at 497.

⁵⁰ *Id.*

So it falls to the current Congress to correct these problems—to reform the FSOC's structure by restoring constitutional checks and balances, and in turn to ensure that the FSOC respects fundamental rights of due process and transparency.

Again, I thank the subcommittee for the opportunity to discuss these matters of crucial importance to our markets and to the rule of law that undergirds them.



Statement submitted to the House Financial Services Committee

on

The Designation of Nonbank Financial Institutions as SIFIs and the
Interactions between the FSOC and the Financial Stability Board

Peter J. Wallison
Arthur F. Burns Fellow in Financial Policy Studies
American Enterprise Institute

November 19, 2015

*The views expressed in this testimony are those of the author alone and do not necessarily represent those of the
American Enterprise Institute.*

November 19, 2015

To the Members of the House Financial Services Committee:

Thank you for the opportunity to submit written testimony for this hearing.

My name is Peter J. Wallison. I am the Arthur F. Burns Fellow in Financial Policy Studies at the American Enterprise Institute. The opinions expressed below are mine alone and not necessarily those of the American Enterprise Institute.

The invitation for this hearing noted that its focus will be on both the substance and the procedures employed by the Financial Stability Oversight Council (FSOC) when it designates nonbank financial firms as systemically important financial institutions (SIFIs). In this connection, I believe it is necessary also to discuss the FSOC's relationship with the Financial Stability Board (FSB), a largely European group of financial regulators and central banks of which the Treasury, the Federal Reserve and the SEC are members. I do not believe the FSOC has been candid about the degree to which the decisions of the FSB were, are and will be influential in the FSOC's designation of SIFIs.

General comment on SIFI designations

Before proceeding with a discussion of the FSOC and the FSB, I should note that I do not believe that any nonbank financial institution, no matter how large, should be designated as a systemically important financial institution (SIFI) in the United States. The provisions of the Dodd-Frank Act that authorize FSOC to designate SIFIs are based on the supposition that *interconnections* among large nonbank firms make them vulnerable to failure if one of them fails. This, in turn, it is assumed, will create instability in the US financial system.

Yet, when Lehman Brothers was allowed to fail in 2008 there was no evidence that the firm's interconnections caused significant losses to others. Lehman was a \$650 billion firm—one of the largest in the US financial system—and a major participant in the credit default swap markets. Even though the firm filed for bankruptcy suddenly and unexpectedly at a time of great market anxiety about the health of financial institutions, no other large financial institutions failed or became unstable as a result of its exposure to Lehman. That demonstrates—I think without question—that concern about “interconnections” among large financial institutions is misplaced. While interconnections of some kind certainly exist among financial firms, the exposures involved are simply not large enough to cause the insolvency of other large nonbank financial institutions when one of them fails.

To be sure, chaos followed Lehman's bankruptcy. However, this was the result of the government's sudden and ill-advised reversal of a policy that market participants believed had been established with the rescue of Bear Stearns six months earlier. Market expectations, as a result of this reversal, were completely upended. That caused some losses—most notably at the Reserve Fund, which probably anticipated it would be bailed out with a government rescue of Lehman—but even that money market fund only suffered losses of one or two percent. The purpose of SIFI designations should not be to prevent business failures, or losses to others when businesses fail, but only to prevent conditions in which business failures will bring down major

portions of the US economy. As Lehman demonstrated, that does not happen even with the failure of a very large nonbank firm.

Accordingly, the FSOC should not have the power to designate nonbank financial institutions. It is unnecessary for financial stability and—more important—the designation of a nonbank firm as a SIFI is a statement by the government that the firm is too big to fail. We already have a seemingly insoluble problem with banks that are too big to fail. To extend TBTF to other industries, and disrupt the competitive structures in those industries for no good reason, is seriously bad policy if not folly. Congress should repeal the FSOC's designation authority and perhaps the FSOC itself.

Did Prudential Insurance and MetLife Receive Due Process from the FSOC When They Were Designated?

The way the FSOC has exercised its designation authority is also a reason for repeal of this authority. When Congress authorized the FSOC to designate large nonbank financial firms as SIFIs, it assumed that the FSOC would follow a fair, objective, and fact-based process in exercising that authority. Although officials have asserted that the FSOC's designation decisions have been the result of such a process, that is not supported by the facts.

The Supreme Court and lower courts have always required that an administrative action be based on a rational and objective interpretation of the evidence before the agency. If those standards are not observed, the agency's action is considered arbitrary and capricious under the Administrative Procedure Act. In addition, when Congress adopted the Dodd-Frank Act and authorized the FSOC to designate nonbank financial firms as SIFIs, it undoubtedly believed that the FSOC would make this determination objectively on the basis of a rational weighing of the evidence. The record shows, in my view, that the FSOC is not making its decisions based on evidence, but simply implementing in the United States decisions first made by the FSB.

In 2009, the FSB was deputized by the G-20 leaders, including, of course, President Obama, to reform the international financial system. Most of the members of the BSB are European finance ministers, bank regulators and central banks; the US is represented by the Treasury, the Fed and the SEC. Because of the size and importance of the US financial system, it is reasonable to assume that the Treasury and the Fed are the most important members of the FSB and that little would be done without US concurrence. The Treasury and the Fed are also the most important members of the FSOC; the Treasury secretary is the chair of the FSOC—and most actions cannot be taken without his concurrence—and the Fed is by far the most important financial regulator on a committee of financial regulators.

After receiving its G20 mandate, the FSB determined to proceed by designating certain firms as "global SIFIs," and on July 18, 2013, it designated nine large international insurers—including three large US insurers, AIG, Prudential and MetLife—as global systemically important insurers, or G-SIIs.¹ The FSOC had designated AIG as a SIFI before the FSB had made its designations,

¹ FSB, "Global systemically important insurers (G-SIIs) and the policy measures that will apply to them" July 18, 2013, http://www.financialstabilityboard.org/wp-content/uploads/r_130718.pdf?page_moved=1.

but Prudential was not designated as a SIFI until September 2013 and MetLife not until December 2014.²

In testimony last March before the House Financial Services Committee, Treasury Secretary Lew stated that the FSB “acts by consensus.” A consensus literally means an agreement; synonyms of consensus in most dictionaries are concurrence, harmony, accord, unity and unanimity. So when these three firms were designated by the FSB as G-SIIs the Treasury and the Fed necessarily concurred in the decision. Indeed, they would have been required to do so, given their importance in the US financial system, and the importance of the US financial system in the global system.

This means that months *before* the FSOC designated Prudential or MetLife as SIFIs the Treasury and the Fed—the two most important members of the FSOC—had already determined as members of the FSB to designate Prudential and MetLife as G-SIIs. Obviously, if a firm is a G-SII on a global scale, it is going to be a SIFI in its home country. Thus, whatever process the FSOC might have followed in the designation of Prudential and MetLife, it could not be considered fair, objective and evidence-based if the chairman of the FSOC and the Fed—as members of the FSB—had already decided the issue months before.

Moreover, the FSB has not explained the basis for its designations of Prudential and MetLife, except to say that they were made in conformity with a methodology of the International Association of Insurance Supervisors. Although the methodology was made public, the FSB has never explained how the methodology applied to any of the insurers, including the three US insurers. So the need for an objective evidence-based decision-making process could not be cured in any way by whatever process the FSB may have followed in making its designations.

Clearly, then, the FSOC’s tainted designations of Prudential and MetLife cannot be considered the kind of deliberative process that was sanctioned by Congress when it authorized the FSOC to make SIFI designations. It would not be too much to say, indeed, that the constitutionally mandated due process was violated in the designations of Prudential and MetLife, simply on the ground that the principal decisionmakers had already decided the issue in advance. There is no way that such a decision could be considered free of bias and—literally—prejudice.

Are the Treasury and Fed Bound by Decisions of the FSB?

In addition, there is evidence that the Treasury and the Fed believe they are bound by the decisions at the FSB, possibly including designation decisions. In early February, 2015, the chairman of the FSB, Mark Carney, sent a memorandum to FSB members, notifying them that the FSB considered them to be bound by its decisions. Because of the importance of the US as a member of the FSB, it is highly unlikely that the chairman would have sent this memorandum without the agreement of the Treasury and the Fed.

² FSOC, US Department of the Treasury, Designations, Feb. 4, 2015, <http://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx>.

The memorandum noted that the FSB expects “full, consistent and prompt implementation of [its] agreed reforms.”³ When questioned about this by Chairman Jeb Hensarling at an HFSC hearing last March, Treasury Secretary Lew denied that the US was bound by these “agreed reforms.” Hensarling pointed out that the FSB had recently “exempted” three Chinese banks from the reforms and asked “if these are preliminary suggestions and not rules [by the FSB] why is it that the FSB found it necessary to grant exemptions, specifically to the Chinese?” Secretary Lew had no answer to this question at the hearing.

It is likely that the FSB, which has no enforcement mechanism of its own, expects to follow the pattern of the Basel Committee on Banking Supervision (BCBS) when it makes its designations. In the BCBS, minimum regulatory standards for banks are agreed in Basel and then implemented by BCBS members in their home countries. If the FSB is following the BCBS format, an agreement among all the participating central banks and financial regulators will designate certain financial institutions to be SIFIs; thereafter, any special regulation associated with designation will be carried out by their home country regulators.

If this process is followed, the FSOC will simply implement the FSB’s decisions in the United States. Congress will hold hearings, but there will be no legislation, no debate and no vote. It would be a serious mistake for Congress to acquiesce in SIFI designations because they were made pursuant to an international agreement of regulators. Congress has the authority to review and approve any such agreements, and should exercise that authority. These agreements should not go into effect without an affirmative vote of Congress.

It is important for Congress to keep in mind that regulators are interested in enhancing the breadth of their authority, and an international agreement on regulations broadens their authority because the regulated industries have fewer opportunities to avoid regulation by moving operations elsewhere. Regulators call the freedom of regulated firms to move elsewhere “regulatory arbitrage,” but one advantage of regulatory competition (i.e., different rules in different places) is that it keeps regulation from stifling innovation and change. This is the lesson of the Basel capital accords, which drove many banks to invest in mortgage-backed securities and thus weakened them all at the same time when mortgages declined in value in 2007 and 2008, bringing on the financial crisis.

There are several indications in decisions by the FSOC and the FSB that the FSOC is following the FSB’s lead. For example, after the FSB recommended that if money market mutual funds that have a floating net asset value be subject to capital requirements like banks, the FSOC pressured the Securities and Exchange Commission to adopt such a rule. Similarly, when the FSB recommended that all asset managers with assets of more than \$100 billion be subject to prudential regulation, the Office of Financial Research, another Treasury agency created by Dodd-Frank, produced two reports at the request of the FSOC to support the idea that large asset managers should be designated as SIFIs. After the FSB designated three US insurance firms as SIFIs—AIG, Prudential, and MetLife—and the FSOC designated Prudential and MetLife as SIFIs.

³ Mark Carney, Memorandum to G20 Finance Ministers and Central Bank Governors, February 4, 2015, <http://www.financialstabilityboard.org/wp-content/uploads/FSB-Chair-letter-to-G20-February-2015.pdf>.

These parallel decisions again suggest that unless Congress asserts its interests, the SIFI designation process will devolve into the implementation of policies and decisions of the FSB.

This raises questions about the objectivity of the investigative and analytical work that the FSOC is supposed to do before declaring US firms to be SIFIs under the Dodd-Frank Act—a concern that is fully validated by the kind of analysis the FSOC did in the Prudential case. There, the FSOC produced what can only be called a perfunctory decision. All the bank regulators, who know nothing about insurance regulation, voted for designating Prudential as a SIFI; however, Roy Woodall, the sole voting member of the FSOC who has insurance expertise and is the Independent Person appointed to the FSOC because of his insurance knowledge, had this to say in his dissent:

In making its Final Determination, the Council has adopted the analysis contained in the Basis [the FSOC’s statement of its reasoning and analysis]. Key aspects of said analysis are not supported by the record or actual experience; and, therefore, are not persuasive. The underlying analysis utilizes scenarios that are antithetical to a fundamental and seasoned understanding of the business of insurance, the insurance regulatory environment, and the state insurance company resolution and guaranty fund systems. As presented, therefore, the analysis makes it impossible for me to concur because the grounds for the Final Determination are simply not reasonable or defensible, and provide no basis for me to concur.

Virtually the same thing happened with the designation of MetLife. Mr. Woodall again found it necessary to dissent because of his view that the decision was not a reasoned consideration of the evidence. This should not be surprising. After MetLife sued the FSOC on the ground that the decision was arbitrary and capricious, the FSOC’s brief contained this argument for why MetLife’s “material distress” could result in “instability” in the US financial system:

MetLife’s distress could lead to significant market uncertainty, which, in turn, could propagate disruptions across the financial system. For example, market participants, unable to know how, or to what extent, their own counterparties are exposed to MetLife, could withdraw from potentially exposed firms and markets in an effort to mitigate their risks.

Arguments like this are entirely fanciful and speculative. If they are ultimately supported by the courts, the purposes of the Administrative Procedure Act—to bring rationality and objectivity to administrative actions—would be gutted. The likely reason that the FSOC had to use arguments like this is that it wanted to follow the FSB’s designation of MetLife, but did not have the evidence required under US law.

If in fact the FSOC, the Treasury and the Fed believe they are bound by FSB decisions, there is a further reason for seeing the FSOC’s designation of Prudential and MetLife as illegitimate. The designation decision was in effect made by the FSB and not by the FSOC.

There is further support for this conclusion in the course of the HFSC’s hearing last March. In answering chairman Hensarling’s question about whether the FSB’s decisions were binding on

the FSOC, Secretary Lew stated that “what the FSB does is it raises global—the goal for global standards to a high level... We work in the FSB to try to get the kinds of standards that we think are appropriate in the United States to be adopted around the world so that the whole world will have high standards.”

The first thing to note about this statement is that it validates Chairman Hensarling’s concern that the FSB, as well as the Treasury and Fed, are treating the FSB’s decisions as binding on the FSB members. Obviously, if the US is trying to raise global standards through the FSB, it would be essential to have those standards viewed as mandatory rather than optional. This explains why the FSB gave an “exemption” to the Chinese banks; that wouldn’t have been necessary, as Chairman Hensarling suggested, if the FSB’s rules were not binding on China.

But Secretary Lew’s response suggests even more than this. If, as the Secretary avers, the US is using the FSB as a mechanism for raising “global standards” to a level that “we think are appropriate in the United States,” this must mean that the Treasury and the Fed believe they must also implement these decisions in the United States. Other countries would not follow the FSB’s directives unless the US were similarly bound.

Conclusion

There is considerable evidence that the FSOC is implementing the decisions of the FSB in the United States and not providing due process to nonbank financial firms that it is considering to designation as SIFIs. For this reason, and because the designation of nonbank firms as SIFIs is both unnecessary for financial stability and destructive of competition in the industries affected, the authority of FSOC to make SIFI designations should be repealed.

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**BASIS FOR THE FINANCIAL STABILITY OVERSIGHT COUNCIL'S
FINAL DETERMINATION REGARDING METLIFE, INC.**

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1. INTRODUCTION**1.1 Council Determination**

The Financial Stability Oversight Council (Council) was established in 2010 with three purposes: to identify risks to U.S. financial stability; to promote market discipline; and to respond to emerging threats to the stability of the United States financial system.¹ To address potential risks to U.S. financial stability, the Dodd-Frank Act authorizes the Council to determine that certain nonbank financial companies shall be supervised by the Board of Governors of the Federal Reserve System (Board of Governors) and be subject to enhanced prudential standards.

Because MetLife, Inc. (MetLife) is a significant participant in the U.S. economy and in financial markets, is interconnected to other financial firms through its insurance products and capital markets activities, and for the other reasons described below, material financial distress at MetLife could lead to an impairment of financial intermediation or of financial market functioning that would be sufficiently severe to inflict significant damage on the broader economy. Based on the Council's evaluation of all the facts of record in light of the factors that the Council is statutorily required to consider, the Council has made a final determination that material financial distress at MetLife could pose a threat to U.S. financial stability and that MetLife will be supervised by the Board of Governors and be subject to enhanced prudential standards.

The Council's final determination does not constitute a conclusion that MetLife is experiencing, or is likely to experience, material financial distress. Rather, consistent with the statutory standard for determinations by the Council under section 113 of the Dodd-Frank Act, the Council has determined that material financial distress at the company, if it were to occur, could pose a threat to U.S. financial stability.

1.2 Engagement with MetLife

In making its determination, the Council carefully considered a broad range of information available through public and regulatory sources, as well as information provided by MetLife. The Council's determination is based on extensive qualitative and quantitative analyses regarding MetLife, taking into account the company's businesses and activities and company-specific financial analysis.

On July 16, 2013, the Council notified MetLife that the company was under consideration for a proposed determination by the Council. The company was invited to meet with staff and to submit materials, and the Council also requested specific information relevant to the Council's evaluation. Between September 2013 and September 2014, staff of Council members and their agencies met with MetLife's representatives 12 times. These staff were subject to the direction of the Council's Deputies Committee and Nonbank Financial Company Designations Committee, both of which include representatives of all of the Council members. In addition, representatives of the company met with senior officials of Council members and member agencies. Staff also had five meetings with two state insurance regulatory authorities with

¹ See Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) section 111, 12 U.S.C. § 5321.

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jurisdiction over MetLife's insurance subsidiaries. MetLife submitted over 21,000 pages of materials to the Council during its evaluation.

On September 4, 2014, the Council voted to make a proposed determination regarding MetLife. On the same day, the Council sent the company a notice and explanation of the basis of the proposed determination, which provided an extensive analysis of the potential for material financial distress at MetLife to pose a threat to U.S. financial stability. The notice also informed the company of its right to request a hearing before the Council to contest the proposed determination. On October 3, 2014, MetLife requested a written and an oral hearing before the Council, which was granted by the Council. MetLife submitted written hearing materials to the Council on October 16, 2014. An oral hearing before the full Council was held on November 3, 2014. On November 10, 2014, the company submitted additional written materials to supplement the materials presented during the oral hearing.

The company's submissions to the Council before and after the proposed determination were considered by the Council. On December 18, 2014, the Council voted to make a final determination regarding MetLife, and provided the company with a detailed statement of the basis for the Council's decision.²

The statement of the basis for the final determination that the Council provided to MetLife relies extensively on nonpublic information that was submitted by MetLife to the Council. For example, that analysis includes information such as the types and amounts of counterparty exposures to MetLife arising from the company's securities issuances, guaranteed investment contracts (GICs), and derivatives activities; the size, collateralization, and liquidity of the company's securities lending program; the impact on capital of the company's use of captive reinsurance; the terms of inter-affiliate transactions; and the scale of the company's insurance liabilities with discretionary withdrawal features. The Council is subject to statutory and regulatory requirements to maintain the confidentiality of certain information submitted to it by a nonbank financial company under review for a potential determination.³ As a result, this public explanation of the basis for the Council's final determination omits such information and addresses the key factors that the Council considered in its evaluation of MetLife and the primary reasons for the Council's determination. This explanation of the basis is intended to provide Congress and the public with an understanding of the Council's analysis while protecting sensitive, confidential information submitted by MetLife to the Council.

1.3 The Legal and Analytic Framework for a Final Determination

The Council may determine that a nonbank financial company will be supervised by the Board of Governors and be subject to prudential standards if the Council determines that (1) material financial distress at the nonbank financial company could pose a threat to the financial stability of the United States (the First Determination Standard) or (2) the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the nonbank financial company could pose a threat to the financial stability of the United States (the Second Determination

² The nonpublic statement of the basis of the Council's decision that the Council provided to MetLife constitutes part of the Council's administrative record regarding MetLife.

³ See Dodd-Frank Act section 112(d)(5), 12 U.S.C. § 5322(d)(5); 12 C.F.R. part 1310.20(e).

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Standard).⁴ The Council may subject a nonbank financial company to Board of Governors supervision and enhanced prudential standards if either the First or Second Determination Standard is met. The Council evaluated MetLife under the First Determination Standard.

In considering whether to make a determination that a nonbank financial company will be supervised by the Board of Governors and subject to enhanced prudential standards, the Council is required to consider the following 10 statutory factors:⁵

1. the extent of the leverage of the company;
2. the extent and nature of the off-balance-sheet exposures of the company;
3. the extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies;
4. the importance of the company as a source of credit for households, businesses, and State and local governments and as a source of liquidity for the United States financial system;
5. the importance of the company as a source of credit for low-income, minority, or underserved communities, and the impact that the failure of such company would have on the availability of credit in such communities;
6. the extent to which assets are managed rather than owned by the company, and the extent to which ownership of assets under management is diffuse;
7. the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company;
8. the degree to which the company is already regulated by 1 or more primary financial regulatory agencies;
9. the amount and nature of the financial assets of the company; and
10. the amount and types of the liabilities of the company, including the degree of reliance on short-term funding.

In determining that material financial distress at MetLife could pose a threat to U.S. financial stability, the Council considered each of the statutory considerations in section 113 of the Dodd-Frank Act and all of the facts of record.

The Council adopted a rule and interpretive guidance (Interpretive Guidance)⁶ that describe the manner in which the Council applies the statutory standards and considerations, and the processes and procedures that the Council follows, in making determinations under section 113

⁴ Dodd-Frank Act section 113(a)(1), 12 U.S.C. § 5323(a)(1).

⁵ The Council may also consider any other risk-related factors that it deems appropriate. Dodd-Frank Act section 113(a)(2), 12 U.S.C. § 5323(a)(2).

⁶ 12 C.F.R. part 1310, app. A.

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of the Dodd-Frank Act. The rule and Interpretive Guidance describe the factors that the Council intends to use when analyzing companies at various stages of the determination process, including sample metrics. The Council's ultimate assessment of whether a nonbank financial company meets a statutory standard for determination is based on an evaluation of each of the statutory considerations, taking into account facts and circumstances relevant to the company.

The Interpretive Guidance explains the analytic framework developed by the Council to group the 10 statutory considerations into six categories: size, interconnectedness, substitutability, leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny. The Council analyzes a nonbank financial company using appropriate quantitative and qualitative data relevant to each of these six categories.

The Interpretive Guidance also defines statutory terms relevant to the determinations process. The Interpretive Guidance states that the Council will consider a "threat to the financial stability of the United States" to exist "if there would be an impairment of financial intermediation or of financial market functioning that would be sufficiently severe to inflict significant damage on the broader economy." The Interpretive Guidance also reflects the belief of the Council that "material financial distress" exists when a nonbank financial company "is in imminent danger of insolvency or defaulting on its financial obligations."

As history has shown, including in 2008, financial crises can be hard to predict and can have consequences that are both far-reaching and unanticipated. Consistent with the Council's mission under the Dodd-Frank Act to identify potential threats before they occur, and as described in the Interpretive Guidance, the Council's analysis focuses on the potential consequences of material financial distress at MetLife "in the context of a period of overall stress in the financial services industry and in a weak macroeconomic environment." As a result, the Council considered a range of outcomes that are possible but vary in likelihood. The Council's approach is consistent with the statutory standard set forth in the Dodd-Frank Act; it considers the range of potential outcomes of MetLife's material financial distress, rather than relying on a specific worst-case scenario. There may be scenarios in which material financial distress at MetLife would not pose a threat to U.S. financial stability, but there is a range of possible alternatives in which it could do so.

1.4 Transmission Channels for Material Financial Distress

In evaluating MetLife, the Council assessed how the company's material financial distress could be transmitted to other firms or markets, thereby causing a broader impairment of financial intermediation or of financial market functioning. An impairment of financial intermediation and financial market functioning can occur through several channels. In the Interpretive Guidance, the Council identified the following channels as most likely to facilitate the transmission of the negative effects of a nonbank financial company's material financial distress to other financial firms and markets:

- *Exposure.* Through this transmission channel, the Council evaluates if a nonbank financial company's creditors, counterparties, investors, or other market participants have exposure to the company that is significant enough to materially impair those creditors, counterparties, investors, or other market participants and thereby pose a threat to U.S. financial stability.

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- *Asset liquidation.* The Council assesses whether a nonbank financial company holds assets that, if liquidated quickly, would cause a fall in asset prices and thereby significantly disrupt trading or funding in key markets or cause significant losses or funding problems for other firms with similar holdings.
- *Critical function or service.* The evaluation of this transmission channel considers the potential effects if a nonbank financial company is no longer able or willing to provide a critical function or service that is relied upon by market participants and for which there are no ready substitutes.

In addition to these three transmission channels, the Interpretive Guidance notes that the threat a nonbank financial company may pose to U.S. financial stability is likely to be exacerbated if the company is sufficiently complex, opaque, or difficult to resolve in bankruptcy such that its resolution in bankruptcy would disrupt key markets or have a material adverse impact on other financial firms or markets. A company's resolvability may mitigate or aggravate the potential for the company to pose a threat to U.S. financial stability.

1.5 Determination that MetLife is Predominantly Engaged in Financial Activities

The Council is authorized to determine that a nonbank financial company will be subject to supervision by the Board of Governors and to enhanced prudential standards.⁷ A company is a nonbank financial company, and thus eligible for a determination by the Council, if it is predominantly engaged in financial activities, subject to certain exceptions.⁸ Section 102(a)(6) of the Dodd-Frank Act provides that a company is predominantly engaged in financial activities if at least 85 percent of the company's and all of its subsidiaries' annual gross revenues are derived from, or at least 85 percent of the company's and all of its subsidiaries' consolidated assets are related to, "activities that are financial in nature" as defined in section 4(k) of the Bank Holding Company Act of 1956, as amended.⁹

More than 85 percent of MetLife's revenues are derived from activities that are financial in nature, and more than 85 percent of MetLife's assets are related to activities that are financial in nature.¹⁰ Thus, MetLife is a nonbank financial company and is eligible for a final determination by the Council.

2. DESCRIPTION OF METLIFE

2.1 Overview

MetLife is a significant participant in financial markets and the U.S. economy and is significantly interconnected to insurance companies and other financial firms through its products and capital markets activities.¹¹ MetLife, Inc., a Delaware corporation, is a publicly

⁷ See Dodd-Frank Act section 113, 12 U.S.C. § 5323.

⁸ Dodd-Frank Act section 102(a)(4), 12 U.S.C. § 5311(a)(4).

⁹ Dodd-Frank Act section 102(a)(6), 12 U.S.C. § 5311(a)(6). See also 12 C.F.R. part 242.

¹⁰ See Bank Holding Company Act section 4(k)(4)(B) and (I), 12 U.S.C. §§ 1843(k)(4)(B) and (I).

¹¹ As noted above, the Council is subject to requirements to maintain the confidentiality of certain information submitted to it by a nonbank financial company under review for a potential determination. As a result, this public explanation of the basis for the Council's final determination omits such information.

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traded holding company headquartered in New York, New York. MetLife is the largest publicly traded U.S. insurance organization¹² and one of the largest financial services companies in the United States,¹³ based on total assets. As of September 30, 2014, MetLife had \$909 billion of total consolidated assets, consisting of approximately \$516 billion of general account invested assets (including cash and cash equivalents) and \$319 billion of separate account assets.¹⁴ In addition, MetLife had \$71 billion of total equity.^{15, 16} As of September 30, 2014, MetLife's market capitalization was approximately \$61 billion.

Through its subsidiaries,¹⁷ MetLife is a leader in providing a wide array of financial services, including group and individual life insurance, annuity products, and retirement-related products and services. MetLife is the largest provider of life insurance in the United States as measured by total SAP admitted assets¹⁸ and gross life insurance in-force, with \$4.4 trillion of gross life insurance in-force (excluding annuities) as of December 31, 2013.¹⁹ As of year-end 2013, MetLife operated in approximately 50 countries through 359 subsidiaries.²⁰

As of September 30, 2014, more than 75 percent of MetLife's assets and revenues were derived from its U.S. and Latin American operations (the company's Americas segment). MetLife's assets located outside of the United States are predominantly in Asia.²¹ Other geographic regions include Asia; and Europe, the Middle East and Africa (EMEA). MetLife's U.S. operations are managed by line of business, including Retail; Group, Voluntary & Worksite Benefits; and Corporate Benefit Funding. The Retail line of business provides whole life, term life, variable life, and universal life insurance; disability and property and casualty insurance; and fixed and variable annuities. The Group, Voluntary & Worksite Benefits business line provides term life, variable and universal life, disability, dental, and property and casualty insurance. The Corporate Benefit Funding line of business primarily manages the company's institutional business, which offers insurance, annuity, and investment products that include GICs, funding agreements, other stable value products, and separate account contracts for the

¹² SNL Financial, data as of September 30, 2014.

¹³ SNL Financial, data as of September 30, 2014.

¹⁴ MetLife Quarterly Report on Form 10-Q for the quarter ended September 30, 2014, p. 4. See section 2.4 for a discussion of the differences between general and separate accounts.

¹⁵ MetLife Quarterly Report on Form 10-Q for the quarter ended September 30, 2014, p. 4. Publicly traded insurance organizations report financial data prepared on the basis of generally accepted accounting principles (GAAP); unless otherwise noted, financial data cited herein were prepared on a GAAP basis. Licensed insurance companies, including subsidiaries of publicly traded companies, are also required to file financial data prepared on the basis of statutory accounting principles (SAP) for state regulatory reporting purposes.

¹⁶ See Appendix A for the company's consolidated balance sheet as of September 30, 2014.

¹⁷ Consistent with the Dodd-Frank Act, the Council's determination is with respect to MetLife, Inc., the holding company of the MetLife organization. However, because the business and activities of MetLife, Inc. are conducted primarily through its subsidiaries, the Council's analysis considered the potential effects of material financial distress at one or more of the company's significant subsidiaries as well as at the holding company. Therefore, depending on the context, references to "MetLife" may refer to the holding company or to the holding company and one or more of its subsidiaries.

¹⁸ An insurer's statutory admitted assets are assets which can be valued and included on the balance sheet to determine financial viability of the company.

¹⁹ SNL Financial, using data prepared on the basis of SAP.

²⁰ MetLife Annual Report on Form 10-K for the year ended December 31, 2013, p. 44 and Exhibit 21.1.

²¹ MetLife Quarterly Report on Form 10-Q for the quarter ended September 30, 2014, p. 19.

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investment management of defined benefit and defined contribution plan assets.²² In addition, MetLife provides institutions with products to fund post-retirement benefits and corporate-owned, bank-owned, insurance company-owned life insurance, and trust-owned life insurance (COLI, BOLI, ICOLI, and TOLI, respectively) for certain corporate employees.²³

MetLife's U.S. insurance company subsidiaries are regulated and supervised by their respective home state insurance regulatory authorities. As of December 31, 2013, those states, among others, include New York, Connecticut, Delaware, Rhode Island, and Missouri.²⁴

Domiciled in New York, Metropolitan Life Insurance Company (MLIC), one of MetLife's wholly owned subsidiaries, has approximately \$396 billion in assets,²⁵ over 40 percent of MetLife's total consolidated assets. MLIC underwrites life insurance and issues annuity products, which are sold to individuals, corporations, and other institutions and their employees.²⁶

On November 17, 2014, MetLife announced that it had completed a merger of four insurance subsidiaries (MetLife Investors USA Insurance Company, MetLife Investors Insurance Company, Exeter Reassurance Company Ltd., and MetLife Insurance Company of Connecticut) into a single surviving company domiciled in Delaware named MetLife Insurance Company USA.²⁷ Before the merger, these entities had total combined assets of over \$150 billion (on a SAP basis).²⁸

²² MetLife Quarterly Report on Form 10-Q for the quarter ended September 30, 2014, pp. 11-12. MetLife Annual Report on Form 10-K for the year ended December 31, 2013, pp. 8-9.

²³ MetLife Quarterly Report on Form 10-Q for the quarter ended September 30, 2014, pp. 11-12. See MetLife, COLI/BOLI overview, available at https://www.metlife.com/institutional-retirement/plan-sponsors/coli-boli/index.html?WT.ac=GN_institutional-retirement_plan-sponsors_coli-boli#overview.

²⁴ See MetLife Annual Report on Form 10-K for the year ended December 31, 2013, pp. 311, 313.

²⁵ MLIC of the State of New York, Statutory Filing for the quarter ended September 30, 2014, p. Q02, available at http://investor.metlife.com/phoenix.zhtml?c=121171&p=irol-statutory_MLIC.

²⁶ MLIC of the State of New York, Statutory Filing for the year ended December 31, 2013, Management's Discussion and Analysis, p. 1. As of year-end 2013, 924 life and health insurance companies were in business in the United States, offering approximately \$570 billion of life insurance protection through individual policies and group certificates. In the first nine months of 2014, MLIC wrote over \$62 billion in direct premiums, including life insurance (no annuity), annuity product considerations, deposit-type contracts, and other considerations, which is more than any other insurance company. See MLIC of the State of New York, Statutory Filing for the quarter ended September 30, 2014, p. Q06. See also Federal Insurance Office, U.S. Department of the Treasury, "Annual Report on the Insurance Industry" (September 2014), available at http://www.treasury.gov/initiatives/fio/reports-and-notices/Documents/2014_Annual_Report.pdf.

²⁷ MetLife Press Release, "MetLife Completes Merger of Three Life Insurance Companies and One Former Offshore Reinsurance Subsidiary" (November 17, 2014), available at <https://www.metlife.com/about/press-room/index.html?compID=150359>.

²⁸ SNL Financial, data as of December 31, 2013.

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2.2 Certain Institutional and Capital Markets Products and Activities

2.2.1 Overview

MetLife leads the U.S. life insurance industry in certain institutional products and capital markets activities, such as issuances of funding agreement-backed notes (FABNs),²⁹ guaranteed minimum return products (such as general and separate account GICs), and securities lending activities. These activities expose other market participants to MetLife and create on- and off-balance sheet liabilities that increase the potential for asset liquidations by MetLife in the event of its material financial distress. Efforts to hedge such risks through derivatives and other financial activities are imperfect and further increase MetLife's complexity and interconnectedness with other financial markets participants.

2.2.2 Funding Agreements and Funding Agreement-Backed Securities

MetLife's funding agreements and related products, its FABNs and funding agreement-backed commercial paper (FABCP), constitute a significant portion of the company's capital markets financing activities and contribute to the company's operating leverage.³⁰ MetLife issued approximately 75 percent of all FABNs issued by U.S. life insurers in the first six months of 2013.³¹ These funding agreement-related instruments could contribute to or exacerbate the transmission of MetLife's material financial distress through the exposure and asset liquidation transmission channels.

In general, funding agreements are investment products issued out of the general account of an insurer into the institutional market. In MetLife's funding agreement-backed securities program, an insurer sponsors the establishment of a limited liability company to act as a special purpose vehicle (SPV) and issues a funding agreement to the SPV.³² Generally, a funding agreement is a direct senior obligation of the sponsoring insurance company. The SPV issues notes that provide the note holders with a security interest in the underlying funding agreement. Under the terms of a funding agreement, the insurance company agrees to pay interest and principal on the amounts borrowed from the SPV. The funding agreement is the SPV's primary asset and the source of funds to pay the note holders.³³ In 2013, MetLife issued \$49.2 billion, and repaid \$48.6 billion,

²⁹ See Fitch Ratings Special Report: "U.S. Funding Agreement-Backed Note Market Update: Tepid Market Since 2009" (December 10, 2013), p. 1. MetLife also has funding agreements through a program with the Federal Agricultural Mortgage Corporation (Farmer Mac). MetLife Quarterly Report on Form 10-Q for the quarter ended September 30, 2014, p. 170.

³⁰ Certain funding agreements, GICs and all other "deposit-type contracts" do not incorporate insurance risk. The National Association of Insurance Commissioners (NAIC) defines these deposit-type contracts as "contracts issued by insurers that do not incorporate risk from the death or disability of policyholders (mortality or morbidity risk) are more comparable to financial or investment instruments issued by other financial institutions than to insurance contracts." See NAIC Accounting Practices and Procedures Manual (2013).

³¹ Based on data downloaded from a Bloomberg terminal as of March 20, 2014, and Council analysis.

³² MetLife Annual Report on Form 10-K for the year ended December 31, 2013, p. 9.

³³ See Fitch Ratings Special Report, "FA-Backed Notes: From Zero to \$135 Billion in Eight Years" (March 3, 2005), p. 4; Moody's Investors Service, "MetLife Short Term Funding LLC" (September 11, 2013), p. 4; See A.M. Best, "Rating Funding Agreement-Backed Securities Programs" (November 2, 2011), p. 3, available at <http://www.ambest.com/ratings/fundagreementmethod.pdf>; Metropolitan Life Global Funding I, prospectus for \$25 billion Global Note Issuance Program (September 2012), p. 10; MetLife Institutional Funding II, prospectus for \$7 billion Global Medium Term Note Issuance Program (September 2012), p. 5.

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in funding agreements. As of September 30, 2014, the company's total obligation outstanding under these funding agreements was \$52.3 billion.³⁴ MetLife's private placement FABNs outstanding increased by 50 percent between the beginning of 2009 and the end of 2013, from \$10 billion to \$15 billion, and has subsequently decreased to approximately \$13 billion.³⁵

Because these instruments are of varying maturities, some of which are short-term, MetLife is exposed to liquidity risk in the event that its investors determine not to renew their investment in MetLife's funding agreement-backed securities. This risk likely would increase if MetLife were to experience material financial distress and the program lost its prime rating.

Through its FABCP program, MetLife typically issues a funding agreement to a commercial paper conduit, which is funded through the issuance of commercial paper. The issued funding agreements do not necessarily match the maturity of the commercial paper. The FABCP is short-term, which exposes MetLife to the risk that its investors could determine not to renew their investment in MetLife's FABCP, particularly if MetLife were to experience material financial distress. MetLife's insurance companies act as liquidity backstops in the event that the FABCP is not renewed.³⁶ Similarly, certain borrowings under MetLife's other funding agreement-related contracts can be subject to rollover risk, which creates additional liquidity risk for MetLife.

If MetLife were to experience material financial distress, MetLife may not be able to roll over its fixed-maturity funding agreement-backed securities, extend its funding agreement-backed securities with embedded put options, or maintain its securities lending transactions in connection with its funding agreement-backed securities programs, which could force MetLife to liquidate assets, including illiquid assets, if the organization's liquid assets were insufficient to meet this unexpected demand.³⁷ In addition, MetLife's funding agreements and funding agreement-backed securities create exposures to MetLife for the holders of those instruments.

2.2.3 Securities Lending

MetLife's securities lending program provides the organization with a meaningful source of funding and operating leverage. Under the securities lending program, MetLife was liable for cash collateral under its control of approximately \$30 billion as of September 30, 2014.³⁸ Of that amount, \$8 billion related to securities (primarily U.S. Treasury and agency securities) that could be returned to MetLife within one business day, requiring the immediate return of cash collateral held by MetLife.³⁹ MetLife uses the cash collateral under this program to purchase additional securities, which can be less liquid than the securities lent.⁴⁰ The securities MetLife purchased

³⁴ MetLife Annual Report on Form 10-K for the year ended December 31, 2013, p. 154.

³⁵ Data downloaded from a Bloomberg terminal as of March 20, 2014.

³⁶ Moody's Investors Service, "MetLife Short Term Funding LLC, ABCP Program Review" (September 11, 2013), pp. 4-5.

³⁷ Rating agencies have noted that the use of FABCP or FABN programs has the potential to expose an insurer to liquidity and asset-liability management risks that could manifest during times of stressed market conditions. See, e.g., Moody's Investor Service, "US Life Insurers' FANIP Issuance Up On Attractive Funding Costs; Higher ALM Risks but More Spread Income" (May 14, 2014), p. 1.

³⁸ MetLife Quarterly Report on Form 10-Q for the quarter ended September 30, 2014, p. 174.

³⁹ *Id.*

⁴⁰ MetLife Annual Report on Form 10-K for the year ended December 31, 2013, p. 44.

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with the cash collateral as well as the securities lent can generally count as admitted assets for the purpose of satisfying MetLife's state-based regulatory capital requirements.⁴¹ MetLife's securities lending program and the reinvestment of the cash collateral could create or exacerbate certain risks that MetLife could pose to other financial firms and markets in the event of its material financial distress.

2.2.4 GICs and Synthetic GICs

MetLife's GICs are general account and separate account liabilities of its insurance company subsidiaries offered to defined contribution plans directly or through stable value product intermediaries:

- MetLife's basic GIC product, referred to as the "Traditional GIC," is written out of the insurance companies' general accounts and offers clients a fixed or indexed rate investment.⁴²
- The proprietary "Met Managed GIC" is a separate account product that provides a general account guarantee of specified value, notwithstanding any decline in the value of the separate account assets.⁴³ The Met Managed GIC is offered to plan sponsors to support the liabilities of certain qualified benefit plans, and generally allows for employee-directed book-value withdrawals for benefits provided under those plans, including transfers to certain plan investment options and loans to the participant.⁴⁴
- Synthetic GICs are similar to Met Managed GICs (for example, they offer a general account guarantee), but refer to GICs booked as derivatives against underlying assets held by the contract holder rather than by MetLife. MetLife's synthetic GICs provide an insurer's client retirement plans with a minimum interest rate guarantee on their investments and a book value liquidity guarantee. Unlike Traditional GICs and Met Managed GICs, the underlying reference assets are owned and controlled by the plan rather than MetLife.

As of December 31, 2013, MetLife had \$6 billion of traditional GICs outstanding.⁴⁵ MetLife also had \$42 billion of separate account liabilities with guarantees, some of which are separate account GICs.⁴⁶ GIC participant balances are guaranteed up to the contract's book value by MetLife's insurance company subsidiaries and could develop into underfunded liabilities during stressed market conditions. The general account guarantees associated with MetLife's

⁴¹ See Statement of Statutory Accounting Principles No. 103—Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.

⁴² See MetLife letter to SEC and CFTC regarding Stable Value Contract Study (September 26, 2011), available at <https://www.metlife.com/assets/cao/institutional-retirement/MetLifeResponseSEC-CFTC-RFI-StableValueSept2011.pdf>.

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ SNL Financial, data as of December 31, 2013. Based on statutory data, SNL Life Group, Exhibit 7, Deposit type contracts (GI Contracts).

⁴⁶ SNL Financial, data as of December 31, 2013. Based on statutory data, SNL Life Group, Note 32, Analysis of Annuity Actuarial Reserves and Deposit Type Liabilities by Withdrawal Characteristics.

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Traditional GICs and Met Managed GICs could lead MetLife to liquidate assets in the event of unexpected liquidity demands, which could result in the transmission of the negative effects of MetLife's material financial distress through the asset liquidation channel. In a stress scenario, the market value of the MetLife insurers' assets supporting the GICs may be less than book value at the time the contract holder is due to receive a payout or other withdrawal supported by the GICs.

A key feature of MetLife's separate account GIC, the Met Managed GIC, is that contract holders are protected from creditor claims in the event of a failure of the issuing MetLife insurer, because assets are held in the separate account. However, as with the Traditional GIC, Met Managed GICs guarantee payment of participant-initiated transactions, such as withdrawals for benefits, loans, or transfers to other funds within a plan.⁴⁷ GIC participant balances are guaranteed up to the contract's book value by MetLife and could develop into an underfunded liability during stressed market conditions. If MetLife experienced material financial distress and were unable to honor its obligations under these contracts, entities holding these financial guarantees could be exposed to losses. Testing to determine whether the market value of assets backing separate account GIC contracts is adequate to support the contract liabilities guaranteed may mitigate the risk in ordinary times, but could be less effective in the event of broader financial market stress.

As of September 30, 2014, MetLife had \$4 billion of outstanding synthetic GICs.⁴⁸ Because MetLife's insurers do not directly hold these assets, the assets are not consolidated onto MetLife's balance sheet. However, synthetic GICs create exposure to MetLife for the holders of these instruments.

2.3 Captive Reinsurance

Reinsurance is insurance purchased by an insurance company to cover portions of risk on insurance policies issued by that company. Reinsurance can fall within two broad categories: external risk transfer through third-party reinsurers and inter-affiliate risk transfer through so-called "captive" reinsurers. In a typical captive reinsurance transaction, an insurance company reinsures a block of existing business through the captive, which is subject to lower reserve and capital requirements than the ceding insurance company.⁴⁹ The Federal Insurance Office, the Federal Reserve Bank of Minneapolis, rating agencies, and state insurance regulators (independently and through the National Association of Insurance Commissioners (NAIC)) have recently focused attention on the increasing use of transactions between commercial insurance companies and affiliated captive reinsurers that are intended to reduce the amount of overall capital and reserves without actually transferring risk outside of an insurance holding company organization.⁵⁰ MetLife relies on internal and external financing arrangements, including

⁴⁷ MetLife letter to SEC and CFTC regarding Stable Value Contract Study (September 26, 2011), pp. 9-10, available at <https://www.metlife.com/assets/cao/institutional-retirement/MetLifeResponseSEC-CFTC-RFI-StableValueSept2011.pdf>.

⁴⁸ MetLife Quarterly Report on Form 10-Q for the quarter ended September 30, 2014, p. 42.

⁴⁹ See New York Department of Financial Services (NYDFS), "Shining a Light on Shadow Insurance" (June 2013), p. 1, available at http://www.dfs.ny.gov/reportpub/shadow_insurance_report_2013.pdf.

⁵⁰ See Federal Insurance Office, U.S. Department of the Treasury, "Annual Report on the Insurance Industry" (September 2014), pp. 43-44, available at <http://www.treasury.gov/initiatives/fio/reports-and->

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internal receivable assets, investment assets, and letters of credit issued by unaffiliated financial institutions, to provide equity and statutory capital funding to affiliated reinsurance captives.⁵¹ In the event of material financial distress at MetLife, losses for MetLife's customers and counterparties through the exposure transmission channel could be exacerbated due to its use of captives. In addition, the potential for off-balance sheet affiliated captive exposures converting to funded exposures could contribute to asset liquidation risk.

2.4 General and Separate Accounts

A life insurance company's invested assets are held in two types of accounts: the general account and one or more separate accounts. The general account consists of assets and liabilities of the insurance company that are not allocated to separate accounts. Separate accounts consist of funds held by a life insurance company that are maintained separately from the insurer's general assets. An insurer's general account assets are obligated to pay claims arising from its insurance policies, annuity contracts, debt, derivatives, and other liabilities. By contrast, for non-guaranteed separate accounts, the investment risk is passed through to the contract holder; the income, gains, or losses (realized or unrealized) from assets allocated to the separate account are credited to or charged against the separate account. Therefore, non-guaranteed separate account liabilities are not generally directly exposed to the insurer's credit risk because they are insulated from claims of creditors of the insurance company. However, in the case of separate account contracts supported by the general account through guarantees, holders of separate accounts may be directly exposed to the insurer's credit risk.

2.5 Variable Annuities

A variable annuity is a hybrid insurance and securities contract issued by a life insurance company in which the purchaser pays the insurer a sum of money and the insurer promises to make periodic payments to the purchaser either immediately or beginning at some point in the future. The purchase payments often are invested in investment vehicles similar to mutual funds in which the purchaser allocates its money among the investment options available in the contract. Variable annuities commonly offer, for a fee, certain protections—commonly referred to as “riders” or guaranteed living benefits—for payouts, withdrawals, or account values against investment losses or unexpected longevity.

MetLife is a leading variable annuity writer, ranked second in overall variable annuity assets in the United States, and represents approximately 10 percent of the total market share based on net assets.⁵² As of September 30, 2014, MetLife reported \$100 billion of variable annuity account

[notices/Documents/2014_Annual_Report.pdf](#). Ralph S. J. Koijen and Motohiro Yogo, Growing Risk in the Insurance Sector, Federal Reserve Bank of Minneapolis Economic Policy Paper 14-2 (March 2014), available at http://www.minneapolisfed.org/pubs/eppapers/14-2/epp_14-2.pdf; Moody's Investors Service Special Comment, “The Captive Triangle: Where Life Insurers' Reserve and Capital Requirements Disappear” (August 23, 2013), pp. 2-3; NAIC White Paper “Captives and Special Purpose Vehicles” (July 6, 2013), p. 3, available at <http://www.naic.org/store/free/SPV-OP-13-ELS.pdf>. NYDFS, “Shining a Light on Shadow Insurance” (June 2013), pp. 6-7, available at http://www.dfs.ny.gov/reportpub/shadow_insurance_report_2013.pdf.

⁵¹ MetLife Annual Report on Form 10-K for the year ended December 31, 2013, p. 151.

⁵² See Investment News, “Variable Annuities” (February, 24, 2014), p. 1, available at <http://www.investmentnews.com/article/20140224/CHART02/140229937/variable-annuities#>.

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values with guaranteed living benefit features and \$198 billion of variable annuity account values with guaranteed death benefit features.⁵³ Net amount at risk, measured by taking the present value of the guaranteed minimum benefit amount in excess of the current account balance, is a potentially useful indicator of risk in variable annuities. The net amount at risk for guaranteed living benefits is \$1.8 billion (1.8 percent of the separate account balance of \$96 billion), and the net amount at risk for guaranteed death benefits is \$4.6 billion (2.8 percent of the separate account balance of \$163 billion).⁵⁴

Guaranteed living benefits on variable annuity contracts are sensitive to changes in market conditions. Similar to other types of annuity contracts, the cash value of a variable annuity contract can be withdrawn at the discretion of the purchaser, subject to withdrawal fees. Thus, variable annuities, particularly those with guaranteed living benefits, are generally viewed as exposing the issuing insurer to broader risks than those of ordinary protection products like term or whole life insurance.⁵⁵ While hedging can mitigate this risk for an insurer, such hedging activities increase a company's complexity and interconnectedness with other financial institutions.

2.6 MetLife During the Recent Financial Crisis

Like many of its life insurance peers, during the financial crisis, MetLife experienced significant decreases in the value of its assets. MetLife's GAAP total equity significantly decreased between 2007 and the first quarter of 2009, due in part to the reduced value of the company's fixed income portfolio.⁵⁶ Among life insurers, in 2008, MetLife had the second largest amount of unrealized losses, and in 2009, MetLife's unrealized losses amounted to 22.5 percent of all unrealized losses among life insurers.⁵⁷ Although a substantial portion of the decreases in the value of its assets remained unrealized, this experience is indicative of both the scale of MetLife's investments and also the extent to which the value of that portfolio can fall.

MetLife had a variety of available funding options during the financial crisis. At the time, MetLife was a bank holding company, which gave the company access to a range of liquidity and capital sources made available to banking entities. MetLife did use several emergency federal government-sponsored facilities. During 2008 and 2009, MetLife's subsidiary bank accessed the Federal Reserve Term Auction Facility 19 times for a total of \$17.6 billion in 28-day loans and \$1.3 billion in 84-day loans.⁵⁸ In March 2009, MetLife raised \$397 million through the Temporary Liquidity Guarantee Program run by the Federal Deposit Insurance

⁵³ MetLife Quarterly Report on Form 10-Q for the quarter ended September 30, 2014, p. 20.

⁵⁴ Because annuity and life contracts with guarantees may offer more than one type of guarantee in each contract (e.g., both living and death benefits), the amounts may not be mutually exclusive. MetLife Quarterly Report on Form 10-Q for the quarter ended September 30, 2014, p. 20.

⁵⁵ See A.M. Best, "Special Report: U.S. Life/Annuity - Issue Review. Rating Factors for Organizations Using Life Captive Reinsurers" (October 28, 2013), available at http://www3.ambest.com/bestweek/purchase.asp?record_code=218101&AltSrc=26.

⁵⁶ MetLife Quarterly Report on Form 10-Q for the quarter ended March 31, 2009, p. 4; MetLife Quarterly Report on Form 10-Q for the quarter ended June 30, 2007, p. 4.

⁵⁷ See Government Accountability Office (GAO), "Impacts of and Regulatory Response to the 2007-2009 Financial Crisis," GAO-13-583 (June 2013), p. 67.

⁵⁸ See Board of Governors, Term Auction Facility (August 2013), available at http://www.federalreserve.gov/newsevents/reform_taf.htm.

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Corporation (FDIC), which enabled the organization to borrow funds at a lower rate than it otherwise would have been able to obtain.⁵⁹ Additionally, MetLife borrowed \$1.6 billion through the Federal Reserve's Commercial Paper Funding Facility.⁶⁰

MetLife also accessed the capital markets beyond the use of TLGP during the crisis. Notably, the company was able to raise additional capital via debt and equity issuances between April 2008 and July 2009.⁶¹

3. ANALYSIS OF POTENTIAL EFFECTS OF MATERIAL FINANCIAL DISTRESS AT METLIFE

3.1 Transmission Channel Analysis

3.1.1 Overview

Consistent with the Dodd-Frank Act and the Interpretive Guidance, the Council evaluated the extent to which material financial distress at MetLife could be transmitted to other financial firms and markets and thereby pose a threat to U.S. financial stability through the following three transmission channels: (1) the exposures of counterparties, creditors, investors, and other market participants to MetLife; (2) the liquidation of assets by MetLife, which could trigger a fall in asset prices and thereby could significantly disrupt trading or funding in key markets or cause significant losses or funding problems for other firms with similar holdings; and (3) the inability or unwillingness of MetLife to provide a critical function or service relied upon by market participants and for which there are no ready substitutes. In evaluating whether material financial distress at MetLife could be transmitted to other firms and markets through the transmission channels to a degree that could cause a broader impairment of financial intermediation or of financial market functioning, the Council considered the statutory factors set forth in section 113 of the Dodd-Frank Act.

In light of MetLife's size, leverage, interconnectedness with other large financial firms and financial markets, provision of products that may be surrendered for cash at the discretion of its institutional and retail contract holders and policyholders, and impediments to its rapid and orderly resolution, material financial distress at MetLife could have significant adverse effects on a broad range of financial firms and financial markets, and could lead to an impairment of financial intermediation or financial market functioning that could be sufficiently severe to inflict significant damage on the economy. Accordingly, the Council has determined that material financial distress at MetLife could pose a threat to U.S. financial stability. The Council considered a broad range of information in its analysis. No single consideration was determinative in the Council's evaluation, but the following explanation describes important factors considered in the Council's determination regarding MetLife.

⁵⁹ MetLife Annual Report on Form 10-K for the year ended December 31, 2009, p. 18.

⁶⁰ See Board of Governors, Commercial Paper Funding Facility (August 2013), available at http://www.federalreserve.gov/newsevents/reform_cpff.htm.

⁶¹ MetLife Annual Report on Form 10-K for the year ended December 31, 2008, p. 7; MetLife Annual Report on Form 10-K for the year ended December 31, 2009, pp. 67, 94.

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The threat to U.S. financial stability that could be posed by MetLife's material financial distress arises primarily from the exposure and asset liquidation transmission channels, although under certain circumstances the critical function or service channel may exacerbate the extent to which the company's material financial distress could be transmitted to the broader financial system and economy. In addition, MetLife's complexity, intra-firm connections, and potential difficulty to resolve, aggravate the risk that the company's material financial distress could materially impair financial intermediation and financial market functioning.

- Large financial intermediaries have significant exposures to MetLife arising from the company's institutional products and capital markets activities, such as funding agreements, general and separate account GICs, pension closeouts, securities lending agreements, and outstanding indebtedness. The company's material financial distress could also expose certain of MetLife's approximately 100 million⁶² worldwide policyholders and contract holders to losses.
- If MetLife were to experience material financial distress, it could be forced to liquidate assets to meet its obligations to counterparties, contract holders, and policyholders. A potential liquidity strain could arise from MetLife's institutional and capital markets products that are subject to early termination or non-renewal at the option of counterparties, or from the substantial portion of the company's insurance liabilities that policyholders can surrender in exchange for cash value. In lieu of surrender, and as required by state laws, for life insurance products that accrue a cash value (such as universal and whole life insurance policies), policyholders may also borrow against their outstanding policies.⁶³ A large-scale forced liquidation of MetLife's large portfolio of relatively illiquid assets, including corporate debt and asset-backed securities (ABS), could disrupt trading or funding markets. The potential for a forced asset liquidation could be exacerbated by MetLife's leverage, which is among the highest of its peers.
- MetLife has a leading position in several important financial markets, including life insurance, retirement products, and commercial real estate lending. While the transmission of stress could be aggravated through the critical function and service channel, particularly in a period of macroeconomic stress and broader pullbacks by other market participants in the markets in which MetLife is a key player, the company's participation in these markets does not generally appear large enough to cause a significant disruption in the provision of services if the company were to experience material financial distress.

The Council's final determination does not constitute a conclusion that MetLife is experiencing, or is likely to experience, material financial distress. Rather, consistent with the statutory standard for determinations by the Council under section 113 of the Dodd-Frank Act, the Council has determined that material financial distress at the company, if it were to occur, could pose a threat to U.S. financial stability.

⁶² MetLife, "MetLife in the World," available at

<https://www.metlife.com/assets/cao/iws/hp/about/MetLifeCorporateFactSheet.pdf> (accessed December 7, 2014).

⁶³ See, e.g., 18 Del. C. 2911(a) (2014); Ohio Rev. Code Ann. 3915.05(G) (West 2014); N.J. Stat. Ann. 17B:25-8 (West 2014); N.Y. Ins. Law 3203(8)(A) (McKinney 2014); S.C. Code Ann. 38-63-220(l) (2014).

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3.1.2 Exposure Transmission Channel

The exposure to a nonbank financial company that is significant enough to materially impair creditors, counterparties, investors, or other market participants and thereby pose a threat to U.S. financial stability is one of the three channels identified by the Council as most likely to facilitate the transmission of the negative effects of a nonbank financial company's material financial distress or activities to other financial firms or markets. The direct and indirect exposures⁶⁴ of MetLife's creditors, counterparties, investors, policyholders, and other market participants to MetLife are significant enough that MetLife's material financial distress could materially impair those entities or the financial markets in which they participate, and thereby could pose a threat to U.S. financial stability.

Institutional and Capital Markets Exposures

Large financial intermediaries, including global systemically important banks (G-SIBs) and global systemically important insurers (G-SIIs), have significant exposures and interconnections to MetLife through its institutional products and capital markets activities. MetLife's capital markets activities, including securities lending and outstanding indebtedness, create significant exposures to the company, including exposures among G-SIBs and G-SIIs. In addition, large financial intermediaries and other companies have significant exposures to MetLife arising from the company's institutional products, such as general and separate account GICs, funding agreements, and pension closeouts.

As described above, for institutional customers, MetLife offers various insurance, annuity, and investment products that include GICs, funding agreements, other stable value products, and separate account contracts for the investment management of defined benefit and defined contribution plan assets. In addition, MetLife provides institutions with products to fund post-retirement benefits and COLI, BOLI, ICOLI, and TOLI for certain corporate employees. Many of MetLife's institutional products are in separate accounts, but guarantees for these products (for example, minimum value guarantees) are obligations of the general account and therefore are reliant on MetLife's financial strength. If MetLife were to experience material financial distress, it may be unable to honor the guarantees on these institutional products, potentially exposing holders or beneficiaries of these products to losses.

Although some of the exposures from MetLife's institutional products for group plans may be dispersed among individual policyholders, material financial distress at MetLife could force pension plans and other institutional users of these products to write down certain of their assets from book value to market value, which could result in significant costs for the pension plans and potentially also for their institutional sponsors. Additionally, policyholders with investments held in separate accounts have exposures to MetLife arising from minimum value guarantees or

⁶⁴ For the purposes of the Council's analysis, "direct exposures" generally refer to exposures of MetLife's counterparties or investors that arise directly from the transactional relationship with MetLife. "Indirect exposures" generally refer to exposures of market participants that do not arise from direct exposures, and may encompass a market participant's potential losses arising from its exposures to other firms that have direct exposures to MetLife. For example, a firm may be impaired through indirect exposures if its counterparties are unable to satisfy their obligations due to losses from direct exposures to MetLife.

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stable value guarantees covering the amount of any deficiency if the market value of separate account assets falls below the guaranteed level.

Through these institutional products and other activities of MetLife, including the company's capital markets activities, a large number of major financial institutions and corporations are significantly interconnected with and exposed to MetLife. In the event of MetLife's material financial distress, these exposures could impair the ability of those firms to provide financial services and result in a contraction in the supply of financial services that could negatively affect financial market functioning.

The sources of these exposures include MetLife's outstanding GICs. As of December 31, 2013, MetLife had approximately \$6 billion of traditional GICs outstanding.⁶⁵ MetLife had \$42 billion of separate account liabilities with guarantees, some of which are separate account GICs.⁶⁶ As of September 30, 2014, MetLife had approximately \$4 billion of outstanding synthetic GICs.⁶⁷ (MetLife's GICs and synthetic GICs are described in section 2.2.4.)

MetLife is also a participant in the pension closeouts and structured settlements markets, and payments to beneficiaries could be interrupted or reduced in the event of MetLife's material financial distress. In addition, as of March 31, 2014, MetLife manages over \$18 billion of BOLI, COLI, and ICOLI, which expose beneficiaries or guarantors to losses if the market value of the assets were less than the guaranteed value.⁶⁸

Market participants are also directly and indirectly exposed to MetLife as a result of its capital markets activities. Estimated capital markets exposures to MetLife include \$16 billion of outstanding long-term debt;⁶⁹ \$3 billion of junior subordinated debt;⁷⁰ approximately \$30 billion of securities lending agreements;⁷¹ \$5 billion of derivatives liabilities;⁷² \$16 billion of unsecured credit and committed facilities;⁷³ approximately \$52 billion of funding agreement-backed securities, Federal Home Loan Bank (FHLB) financing, and other obligations;⁷⁴ and \$4 billion of net notional single-name credit default swaps where MetLife serves as the reference entity.⁷⁵ The market capitalization of MetLife's common shares outstanding was approximately \$61 billion as of September 30, 2014, but exposures to MetLife arising from its outstanding equity securities do not appear to be a significant direct source of risk to U.S. financial stability.

⁶⁵ SNL Financial, data as of December 31, 2013. Based on statutory data, SNL Life Group, Exhibit 7, Deposit type contracts (GI Contracts).

⁶⁶ SNL Financial, data as of December 31, 2013. Based on statutory data, SNL Life Group, Note 32, Analysis of Annuity Actuarial Reserves and Deposit Type Liabilities by Withdrawal Characteristics.

⁶⁷ MetLife Quarterly Report on Form 10-Q for the quarter ended September 30, 2014, p. 42.

⁶⁸ See MetLife, COLI/BOLI overview, available at https://www.metlife.com/institutional-retirement/plan-sponsors/coli-boli/index.html?WT.ac=GN_institutional-retirement_plan-sponsors_coli-boli#overview.

⁶⁹ MetLife Quarterly Report on Form 10-Q for the quarter ended September 30, 2014, p. 4.

⁷⁰ *Id.*

⁷¹ *Id.* at p. 31.

⁷² MetLife Quarterly Report on Form 10-Q for the quarter ended September 30, 2014, p. 42.

⁷³ *Id.* at p. 171.

⁷⁴ *Id.* at p. 170.

⁷⁵ See Depository Trust & Clearing Corporation, Table 6 as of September 26, 2014, available at <http://www.dtcc.com/products/derivserv/data/index.php>.

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As of September 30, 2014, MetLife maintained two unsecured credit facilities totaling \$4 billion and committed facilities aggregating \$12 billion.⁷⁶ The unsecured credit facilities are used for general corporate purposes, and the committed facilities are used for collateral for certain of MetLife's affiliated reinsurance liabilities.⁷⁷ Under the company's committed facilities, \$6.6 billion in LOCs and \$2.8 billion in aggregate drawdowns under collateral financing agreements were outstanding.⁷⁸

In addition, a significant portion of MetLife's securities lending counterparties are firms whose interconnectedness with the broader financial system could amplify the effect of any losses. MetLife generally lends securities in exchange for cash collateral representing 102 percent of the value of the securities.⁷⁹ MetLife uses the cash collateral to purchase additional securities, which can be less liquid than the securities lent.⁸⁰ MetLife reinvests the cash collateral in securities, including ABS, RMBS (residential mortgage-backed securities), CMBS (commercial mortgage-backed securities), U.S. and foreign corporate securities, and U.S. Treasury and agency securities.⁸¹ If MetLife were to experience material financial distress, its securities lending counterparties, particularly those counterparties holding lower-quality securities (compared with Treasury securities), could have an incentive to close out transactions as quickly as possible in order to withdraw cash collateral and reduce exposure to MetLife or to the borrowed securities. More generally, to avoid market concerns regarding their own financial condition, counterparties and other institutional customers may have an incentive to reduce exposures and disclose the limited extent to which they have a financial relationship with the firm in material financial distress.

MetLife's gross notional amount of derivatives outstanding as of September 30, 2014, was \$406 billion. MetLife's derivatives portfolio includes interest rate derivatives (63 percent by gross notional amount, as of September 30, 2014), equity derivatives (17 percent), foreign exchange derivatives (16 percent), and credit derivatives (3 percent).⁸² MetLife uses equity derivatives and other derivatives to hedge variable annuity guarantees.⁸³

Some counterparties' exposures to MetLife may be material relative to their equity capital, while others are smaller. MetLife's derivatives counterparties, creditors, debt holders, and securities lending and repurchase agreement counterparties include other large financial intermediaries that are interconnected with one another and the rest of the financial sector. Exposures of these large financial firms to MetLife could result in direct losses to those firms as a result of MetLife's material financial distress. For example, at the beginning of 2013, money market mutual funds (MMFs) held over 50 percent of MetLife's FABCP, and a maximum of 65 MMFs could "break the buck" if MetLife were to default on its funding agreement-backed securities.⁸⁴ As witnessed

⁷⁶ MetLife Quarterly Report on Form 10-Q for the quarter ended September 30, 2014, p. 171.

⁷⁷ *Id.*

⁷⁸ *Id.*

⁷⁹ MetLife Annual Report on Form 10-K for the year ended December 31, 2013, p. 131.

⁸⁰ *Id.* at p. 44.

⁸¹ MLIC of the State of New York, Statutory Filing for the year ended December 31, 2013, p. 19.7.

⁸² MetLife Quarterly Report on Form 10-Q for the quarter ended September 30, 2014, p. 42.

⁸³ See MetLife Annual Report on Form 10-K for the year ended December 31, 2013, p. 147.

⁸⁴ Data are as of October 31, 2013, from Securities and Exchange Commission Form N-MFP and Council analysis. An MMF has "broken the buck" (i.e., re-priced its securities below \$1.00 per share) if it is unable to maintain a

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during the 2007-2009 financial crisis, when one MMF breaks the buck, a broader run on MMFs can be triggered. Such an event could lead investors to withdraw from short-term funding markets more broadly, which could impair the ability of large financial firms to serve as financial intermediaries.

The exposures discussed above reflect aggregate gross exposures and do not incorporate the potential mitigating effects from the collateralization of exposures or potential recovery rates. However, a consideration of aggregate gross exposure estimates is relevant because, among other things, it assists in an analysis of the company's interconnectedness and with a comparison of exposures to MetLife with exposures to other financial institutions. Further, exposures to MetLife, even when calculated taking these mitigating factors into account, are substantial and could lead the company's material financial distress to pose a threat to U.S. financial stability.

Exposure of U.S. Policyholders and the Guaranty Associations

Retail policyholders are also directly exposed to MetLife. MetLife has approximately 100 million customers worldwide.⁸⁵ MetLife's material financial distress could directly expose certain of these policyholders and contract holders to losses, particularly those who hold products with cash values and guaranteed benefit features. Retail policies are typically long-term liabilities realized over time, which may minimize the potential impact in any given year. Further, state guaranty and security fund associations (GAs) may mitigate some U.S. policyholder losses from certain insurance and annuity products in the event of insolvency of the insurance company issuing those products. Although the GAs could mitigate some policyholder losses, the GAs only cover certain products and policies up to the point of state-specific coverage limits.⁸⁶ Moreover, due to MetLife's size, scope, the withdrawal features of some of its life insurance and annuity offerings, and broad national presence, the GAs could have insufficient capacity to handle a resolution of one of MetLife's lead insurers, and the liquidation of MetLife's large insurer subsidiaries could strain the GAs' capacity for many years. The total annual GA assessment capacities of all 50 U.S. states, the District of Columbia, and Puerto Rico were

stable net asset value (NAV) per share based on pricing of its portfolio holdings. On July 23, 2014, the SEC adopted MMF reforms that include a floating-NAV requirement for institutional prime MMFs. The MMF reforms do not require a floating NAV for certain funds, including retail MMFs. After the SEC's adoption of those reforms, the Council stated that it intends to monitor the effectiveness of the SEC's reforms in addressing risks to financial stability.

⁸⁵ MetLife, "MetLife in the World," available at <https://www.metlife.com/assets/cao/iws/hp/about/MetLifeCorporateFactSheet.pdf>.

⁸⁶ States have determined the level of protection to be afforded to their respective residents. For example, GA benefit protection for life insurance death benefits is capped at \$300,000 in 44 states and the District of Columbia and \$500,000 in six states. Life insurance cash value coverage is capped at \$100,000 in 41 states and the District of Columbia, while nine states set cash value coverage at various levels above \$100,000. The coverage cap for annuity benefits is at least \$250,000 in most states; it is \$100,000 in two states and Puerto Rico, \$300,000 in eight states and the District of Columbia, and \$500,000 in four states. See "The Life & Health Insurance Guaranty Association System: The Nation's Safety Net," 2014 Edition, National Organization of Life and Health Guaranty Associations (NOLHGA), available at <https://www.nolhga.com/factsandfigures/main.cfm>. Other products, particularly those for defined benefit plans, may be covered by GAs, but because the coverage limit may apply to the entire retirement plan, not each plan participant, the coverage level may be small relative to the size of the contract. Certain institutional products, such as stable value wraps, generally are not covered by GAs.

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\$2.9 billion for life insurance and \$3.4 billion for annuities as of December 31, 2012.⁸⁷ The exposures of MetLife's individual policyholders and institutional customers could cause MetLife's material financial distress to impair those entities and affect financial market functioning and the economy.

Aggregate Exposures and the Risk of Contagion

The negative effects resulting from the material financial distress or failure of a large, interconnected financial firm such as MetLife are not limited to the amount of direct losses suffered by any one of the firm's counterparties, creditors, and customers. MetLife's material financial distress could indirectly affect other firms due to market uncertainty about their exposures to MetLife and the potential impact of such exposures on the financial health of those firms, their counterparties, or the financial markets in which they participate. This type of uncertainty can lead market participants to pull back from a range of firms and markets, in order to reduce exposures, thereby increasing the potential for destabilization. In the event of MetLife's material financial distress, large and leveraged counterparties with direct or indirect exposures to MetLife could engage in behavior that results in a contraction in financial activity by those counterparties as well as others.

3.1.3 Asset Liquidation Transmission Channel

The second channel identified by the Council as most likely to facilitate the transmission of the negative effects of a nonbank financial company's material financial distress or activities to other financial firms or markets is if the company holds a large amount of assets that, if liquidated quickly, could significantly disrupt the operation of key markets or cause significant losses or funding problems for other firms with similar holdings. During a period of overall stress in the financial services industry and in a weak macroeconomic environment, a deterioration in asset prices or market functioning could pressure other financial firms to sell their holdings of affected assets in order to maintain adequate capital and liquidity. This, in turn, could produce a cycle of asset sales that could lead to further market disruptions.

In addition, if MetLife were to experience material financial distress, it could be forced to liquidate assets to meet its obligations to counterparties, contract holders, and policyholders. In order to meet a rapid increase in liquidity demand, MetLife could be forced to sell assets at discount prices, which could impair financial intermediation or financial market functioning.

There are two primary sources of potential liquidity strains that could cause or contribute to a forced asset liquidation by MetLife: institutional and capital markets products that can be terminated or not renewed by the counterparty, and insurance-related liabilities that can be withdrawn or surrendered by the contract holder or policyholder. First, if MetLife experienced material financial distress, it could be forced to sell assets in response to investors' refusal to rollover some of its approximately \$35 billion of FABCP and FABNs outstanding,⁸⁸ or due to

⁸⁷ Assessment capacity is based on written premium volume. See NOLHGA, "Nationwide Capacity, Assessments Called and Refunded Summary" (October 28, 2013), available at <http://www.nolhga.com/resource/file/capacity/2012/R1%20Nationwide%20Capacity.%20Assessments%20Called%20and%20Refunded%20Summary.pdf>.

⁸⁸ MetLife Quarterly Report on Form 10-Q for the quarter ended September 30, 2014, p. 170.

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early returns of securities borrowed in connection with its approximately \$30 billion⁸⁹ securities lending program.

As described above, in its securities lending program, MetLife's insurance company subsidiaries lend securities to third parties in exchange for cash collateral. MetLife generally receives cash collateral equal to at least 102 percent of the fair market value of the lent security.⁹⁰ MetLife uses the cash collateral it receives to purchase securities that can be less liquid than the lent securities and have longer maturities than the duration of the underlying securities loans. This maturity mismatch results in liquidity risk for MetLife.⁹¹ In the event of MetLife's material financial distress, liquidity risk would be increased if its counterparties were to close out their transactions early by returning the borrowed securities to MetLife in order to recoup their cash collateral. In addition, a portion of MetLife's securities lending program is funded with proceeds from the sale of FABNs, which exposes the company to the liquidity risks associated with the actions of securities borrowers as well as potential risks associated with the FABN investors' non-renewal of maturing FABNs.

The second source of potential liquidity strains that could cause or contribute to a forced asset liquidation by MetLife is the portion of the company's retail insurance and annuity products that can be surrendered or withdrawn for cash. While many insurance liabilities are long-term and cannot be withdrawn or converted to cash at the discretion of the policyholder or contract holder, other insurance liabilities relate to products that have been designed and purchased as savings or investment products and have contractual terms that allow varying levels of discretionary withdrawals. The simplest life insurance product, term life insurance, is purely a protection product that does not allow policyholders to withdraw cash immediately or to surrender their policies for a cash value; as a result, it does not pose a run risk.⁹² On the other end of the spectrum are products that can generally be surrendered by a policyholder or contract holder upon demand, for cash, with minimal penalty or adjustment.

MetLife provides products across this spectrum. At year-end 2013, of the \$308 billion in general account liabilities of MetLife's U.S. insurance operating companies, approximately \$49 billion may be withdrawn with little or no penalty.⁹³ A portion of the cash value of these liabilities is available for discretionary withdrawal through policy loans and partial or full surrenders with little or no penalty and therefore could, in some circumstances, take on characteristics of short-term liabilities. Although these products generally are considered to be long-term liabilities and a number of these products include provisions that are designed to disincentivize withdrawals, such as penalties and loss of guarantee accumulation, these disincentives could serve as less of a deterrent if MetLife's ability to meet its obligations were in doubt. Upon requests for early withdrawal or surrender of some portion of these products, an insurer may find it necessary to liquidate securities in its investment portfolio to generate the cash required to meet those

⁸⁹ *Id.* at p. 174.

⁹⁰ *Id.* at p. 152.

⁹¹ MetLife Annual Report on Form 10-K for the year ended December 31, 2013, p. 44.

⁹² See McMenamin, Robert, Zain Mohey-Deen, Anna Paulson, and Richard Rosen, "How Liquid Are U.S. Life Insurance Liabilities?", Federal Reserve Bank of Chicago, Chicago Fed Letter, No. 302 (2012).

⁹³ SNL Financial, data as of December 31, 2013. Based on statutory data, SNL Life Group, Note 32, Analysis of Annuity Actuarial Reserves and Deposit Type Liabilities by Withdrawal Characteristics.

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requests. Further, in lieu of surrenders, some policyholders may opt for partial surrenders or policy loans to reduce the impact of the contractual disincentives while still withdrawing available cash from their policies.

The potential for withdrawals could increase in the event that MetLife experiences material financial distress, as concerns about the company's ability to meet future obligations could induce large numbers of policyholders and contract holders to use or accelerate contractual cash withdrawals or policy loans.

Approximately \$206 billion of MetLife's separate account liabilities can also be withdrawn or transferred, although separate account contract holders generally have stronger disincentives to surrender than general account policyholders.⁹⁴

MetLife's insurance company subsidiaries have the contractual right to defer payouts for up to six months on many of the immediately payable cash surrender values associated with their products.⁹⁵ Further, state insurance regulators could impose stays on policyholder withdrawals and surrenders. An insurance company-imposed moratorium would delay the exercise of certain types of contract holder withdrawal or surrender options available based on contractual features. However, MetLife's insurance company subsidiaries could have disincentives to invoke these options because of the negative signal regarding the company's financial strength that could be sent to counterparties, policyholders, and investors as a result of such actions. Surrenders and policy loan rates could increase if MetLife's policyholders feared that stays were likely to be imposed either by MetLife's insurance company subsidiaries or by their state insurance regulators.

While the exercise of contractual deferral provisions, combined with operational and logistical considerations, could slow any asset liquidation well beyond seven days, moratoria on outflows would not necessarily mitigate the liquidity pressure on MetLife in the event that the organization experiences material financial distress. For example, if MetLife exercised its contractual deferrals at a time when MetLife was experiencing material financial distress, the suspension of insurance and annuity product contract outflows through contractual provisions could spread concern regarding MetLife's financial condition more broadly in the marketplace, which could lead to further liquidity demands as, for example, securities lending counterparties, funding agreement-backed securities investors, and other policyholders with surrenderable liabilities seek to reduce their exposures to MetLife. These increased liquidity demands could prompt additional asset liquidations.

⁹⁴ *Id.*

⁹⁵ Insurance companies may be able to delay payment of some withdrawable liabilities. For example, the NYDFS has for many years required all insurers writing business in the state of New York to include a contractual provision allowing the insurer to impose a stay on outflows connected with an insurance policy or contract. *See* sections 4221 and 4223 of the New York State Insurance Code pertaining to individual policies and contracts (non-variable); *see also* New York Regulations 47 and 77 for individual variable annuity and individual variable life contracts, respectively, at New York Comp. Codes R. & Regs. tit. 11, §§ 50.7(a)(4), 54.6(b)(8)(ii). With respect to group contracts, deferral provisions are typically agreed to by the parties to the contracts. Additionally, state insurance regulators' authorities permit the suspension of certain payment outflows in situations where the regulators have taken control of an insurance company in receivership.

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Further, the imposition of a suspension of insurance policy and annuity product surrender or withdrawal options could cause uncertainty to spread to the customers of other insurance companies offering similar products and could undermine confidence in the broader life insurance industry. If such a situation were to occur during a period of overall stress in the financial services industry and in a weak macroeconomic environment, surrenders at other life insurers could increase, particularly if MetLife's material financial distress were related to a broader economic shock or market event, such as an interest rate spike or impairments in a widely held asset class.

MetLife's portfolio of highly liquid assets may not be sufficient to avoid sales of less-liquid assets in order to meet increased liquidity demands. At least \$37 billion of MetLife's invested assets are encumbered.⁹⁶ MetLife may be unable to quickly sell those assets.

In such a scenario, a large-scale forced liquidation of MetLife's assets could cause significant disruptions to key markets, including corporate debt and ABS markets. MetLife has substantial holdings of various assets that are relatively illiquid.⁹⁷ For example, U.S. corporate fixed income securities represent the largest category of MetLife's assets, and its holdings represent over four days of average daily trading volume (ADTV).⁹⁸ In addition, as of September 30, 2014, MetLife's general account assets invested in U.S. ABS represented over 12 days of the market's ADTV.⁹⁹ Liquidity in the corporate debt and ABS markets has demonstrated the potential to significantly decrease in a period of overall stress in the financial sector and in a weak macroeconomic environment. The large size of these portfolios could make it difficult to liquidate the associated assets, if needed, and any liquidation could put significant pressure on market prices, causing significant losses for other firms with similar holdings. Resulting price dislocations in debt markets could cause significant disruptions in critical funding markets relied upon by the largest and most leveraged financial firms, and in the availability of funding for the broader U.S. economy.

A forced asset liquidation could be exacerbated by the scale and composition of MetLife's financial and operating leverage. MetLife's leverage ratio is among the highest of its peers. MetLife has significant operating debt compared to its peers, largely related to its institutional investment products. MetLife's operating leverage ratio was driven largely by liabilities from its securities lending activities (approximately \$30 billion),¹⁰⁰ FHLB borrowings (\$15 billion),¹⁰¹

⁹⁶ See MLIC of the State of New York, Statutory Filing for the year ended December 31, 2013, p. 19.8; MetLife Investors USA Insurance Company, Statutory Filing for the quarter ended June 30, 2014, p. Q07.4.

⁹⁷ As of September 30, 2014, MetLife held \$108 billion of U.S. corporate securities at fair value, and \$70 billion of asset-backed securities and mortgage-backed securities at fair value. MetLife Quarterly Report on Form 10-Q for the quarter ended September 30, 2014, p. 22.

⁹⁸ Securities Industry and Financial Markets Association (SIFMA), "Statistics," available at <http://www.sifma.org/research/statistics.aspx>.

⁹⁹ *Id.*

¹⁰⁰ MetLife Quarterly Report on Form 10-Q for the quarter ended September 30, 2014, p. 174.

¹⁰¹ *Id.* at p. 170.

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general account traditional GICs (\$6 billion),¹⁰² and funding agreement-backed securities and other funding agreements (\$37 billion).¹⁰³

Moreover, the severity of the disruption caused by a forced liquidation of MetLife's assets could be amplified by the fact that the investment portfolios of many large insurance companies are composed of similar assets, which could cause significant losses for those firms. Significant outflows from MetLife could also put other large life insurers that may also be perceived as vulnerable at risk of similar outflows. The potential erosion of capital and de-leveraging could result in asset fire sales that could disrupt financial market functioning and that could ultimately damage the broader economy.

3.1.4 Critical Function or Service Transmission Channel

MetLife operates in a range of insurance, risk transfer, and capital markets, and has a leading position in several of the key markets in which it offers products or otherwise participates, including life insurance, retirement products, and commercial real estate lending. The company is the leader in the life and health insurance market, with a market share of approximately 15 percent based on premiums written.¹⁰⁴ MetLife is also a significant participant in the corporate benefit funding and annuity product markets. As noted above, MetLife is ranked second in overall variable annuity assets in the United States, and represents approximately 10 percent of the total market share based on net assets.¹⁰⁵ Additionally, MetLife operates lines of business that provide credit to households, businesses, agricultural enterprises, and state and local governments, while also serving as a federal government contractor and a provider of credit to low-income, minority, or underserved communities.

While the withdrawal of a market leader such as MetLife from so many business lines could aggravate the transmission of MetLife's material financial distress through the critical function or service channel, most of the key insurance markets in which MetLife operates appear to be competitive, and other firms would likely be able to absorb the increased demand for products and services if MetLife ceased to offer them. MetLife's shares in these generally fragmented and competitive markets do not appear large enough to cause a significant disruption in the provision of services if the company were to experience material financial distress and were unable or unwilling to provide services. Certain markets in which MetLife is a significant participant are more concentrated and potentially less substitutable, such as the corporate benefit funding market, but MetLife's participation in these markets has fluctuated considerably. In addition, it is unclear whether these markets are sufficiently large or interconnected with the broader financial system such that MetLife's withdrawal from these markets could pose a threat to U.S.

¹⁰² SNL Financial, data as of December 31, 2013. Based on statutory data, SNL Life Group, Exhibit 7, Deposit type contracts (GI Contracts).

¹⁰³ The funding agreement-backed securities and other funding agreements amount includes special purpose entity funding agreements (\$34.5 billion) and Farmer Mac funding agreements (\$2.8 billion). MetLife Quarterly Report on Form 10-Q for the quarter ended September 30, 2014, p. 170.

¹⁰⁴ See Federal Insurance Office, U.S. Department of the Treasury, "Annual Report on the Insurance Industry" (September 2014), p. 9, available at http://www.treasury.gov/initiatives/fio/reports-and-notices/Documents/2014_Annual_Report.pdf.

¹⁰⁵ See Investment News, "Variable Annuities" (February, 24, 2014), p. 1, available at <http://www.investmentnews.com/article/20140224/CHART02/140229937/variable-annuities#>.

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financial stability. Nevertheless, under certain market conditions, the transmission of stress through this transmission channel could be aggravated, particularly in a period of macroeconomic stress and broader pullbacks by other market participants in the markets in which MetLife is a key player.

3.2 Existing Supervision and Regulation

In considering whether to make a final determination regarding MetLife, the Council considered the degree to which MetLife is already regulated by one or more primary financial regulatory agencies.¹⁰⁶ The Council also consulted with certain regulators of MetLife or its insurance company subsidiaries before making a final determination regarding the company.

MetLife is currently not subject to consolidated supervision. The company's subsidiaries are subject to supervision by a number of U.S. and international regulators.¹⁰⁷ MetLife's insurance company subsidiaries are subject to supervision by regulators in all 50 U.S. states, the District of Columbia, the five U.S. territories, and numerous foreign countries.¹⁰⁸ As of December 31, 2013, MetLife's primary U.S. insurance regulators for its life insurance and annuity products businesses are the NYDFS, the Connecticut Insurance Department, and the Delaware Department of Insurance.

A state insurance regulator supervises numerous aspects of a licensed entity's operations, including solvency; pricing and products; investments; reinsurance; reserves; asset-liability matching; transactions with affiliates; use of derivatives; and management. State insurance regulators also have examination authorities. In the United States, MetLife's insurance company subsidiaries are subject to state-based, legal entity regulation. All 50 U.S. states, the District of Columbia, and Puerto Rico are currently accredited under the NAIC's Financial Regulation Standards and Accreditation Program, which requires regulators to demonstrate that they have adequate administrative authority to regulate an insurer's corporate and financial affairs.

Insurance companies are required to prepare financial data and submit quarterly and annual financial statements on the basis of SAP and to provide information describing the businesses and financial matters in which they are engaged. This legal entity-based regulatory reporting regime is used by state insurance regulators to monitor the financial health of state-licensed insurers through quarterly and annual analyses, and on-site examinations are performed at least once every five years.¹⁰⁹ Financial examinations are generally conducted on the basis of financial information covering a period of up to five calendar years prior to the examination as-of date.

¹⁰⁶ See Dodd-Frank Act section 113(a)(2)(H), 12 U.S.C. § 5323(a)(2)(H).

¹⁰⁷ In the United States, insurance companies are licensed and regulated by the chief insurance regulatory authorities of the 50 states, the District of Columbia, and the five U.S. territories. These authorities are members of the NAIC. Primary (or lead) state regulatory authorities for multi-state insurers are determined by state insurance regulatory members of the NAIC.

¹⁰⁸ MetLife's foreign subsidiaries are regulated by the regulatory authorities in those host countries.

¹⁰⁹ For any insurer deemed a troubled company, the reporting, analysis, and examinations are increased in frequency and depth.

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State insurance regulators have a range of authorities. Certain of these authorities are described below. For example, in addition to the regulator's financial analysis and examination authorities, an early intervention tool may be available to certain state insurance regulators if the state insurance regulator finds that an insurer is in hazardous financial condition. The nature of intervention could include requiring an insurer to increase capital and surplus, requiring an insurer to file financial reports and a business plan, or a range of other corrective actions. Another example of state insurance regulatory authority is risk-based capital (RBC) requirements, a capital measurement tool designed to help state insurance regulators detect when progressively more intense levels of intervention may be appropriate. The RBC framework involves calculation of a legal entity-level capital position using a formula specific to the insurance sector within which an insurance company operates and yields the minimum capital standard for an insurance entity. The RBC framework establishes an objective standard for triggering regulatory action when an insurer's RBC ratio falls below certain levels, although insufficient RBC is not the only factor that can be used by a state regulator to intervene when an insurance company is in financial distress. Many variables influence whether, when, and how a state regulator could intervene in the distress of one of MetLife's insurers.

While one or more of the state regulators' authorities may be effective in mitigating the risks arising from an insurance company, these authorities have never been tested by the material financial distress of an insurance company of the size, scope, and complexity of MetLife's insurance subsidiaries.

While the state insurance regulators have authority over MetLife's insurance subsidiaries domiciled in their respective states, state insurance regulators generally do not have direct authority to require a non-mutual holding company of a state-licensed insurer or any non-insurance company subsidiary to take or not take actions outside of the insurer for the purpose of safety and soundness of the insurer or for the avoidance of risks from activities that could result in adverse effects on U.S. financial stability. Also, state regulators do not have direct authority relative to MetLife's international insurance activities.

State regulators and regulators in other countries are also currently involved in the regulatory oversight of MetLife's captive reinsurance companies, which reinsure risk from affiliated companies. As described above, MetLife's use of captive reinsurance subsidiaries generally enables the company to hold lower-quality capital and lower reserves than would otherwise be required, which creates a greater risk that MetLife could be required to liquidate assets to satisfy an increase in demand for liquidity.

For U.S.-domiciled insurance holding companies with operations in multiple jurisdictions, state insurance regulators may convene "supervisory colleges" on a periodic basis. These supervisory colleges are non-public regulator forums that may meet in session on an annual or semi-annual basis. They include the state insurance regulators of the largest insurance company subsidiaries in an insurance holding company and regulators responsible for supervising insurance subsidiaries in other countries, as well as regulatory agencies that may be responsible for supervising the company's non-insurer affiliates. While supervisory colleges may allow state insurance regulators to monitor other parts of an insurance organization, and may enhance communications of confidential supervisory concerns across an enterprise, they are not equivalent to the supervisory and regulatory authorities to which a nonbank financial company that the Council determines shall be subject to supervision by the Board of Governors and

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enhanced prudential standards is subject, nor do they have direct supervisory authority over the holding company or its non-insurance subsidiaries.

MetLife's non-insurance subsidiaries include broker-dealers (regulated by the Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority) and registered investment advisers (regulated by the SEC). MetLife issues variable annuity contracts and variable life insurance policies through separate accounts that are registered with the SEC as investment companies under the Investment Company Act of 1940.¹¹⁰ In addition, the variable annuity contracts and variable life insurance policies issued by these registered separate accounts are registered with the SEC under the Securities Act of 1933.¹¹¹

Further, as described above, GAs may mitigate some policyholder losses from certain insurance and annuity products in the event of insolvency of the insurance company issuing those products. However, due to MetLife's size and broad national presence, the GAs could have insufficient capacity to handle a resolution of one of MetLife's lead insurance underwriters.

From 2001 until early 2013, MetLife was subject to consolidated supervision by the Board of Governors as a bank holding company. While MetLife was under Board of Governors supervision, state insurance regulators supervised the insurance activities of its insurance subsidiaries. During that period, Federal Reserve System staff coordinated with insurance and other regulators to supervise MetLife's subsidiaries. MetLife, Inc. has deregistered as a bank holding company and MetLife is not currently subject to consolidated supervision.

The final determination by the Council regarding MetLife allows the Board of Governors to apply a number of new requirements to MetLife. These include requirements to (1) submit a resolution plan to the Board of Governors and the FDIC providing for its rapid and orderly resolution in the event of its material financial distress or failure;¹¹² (2) comply with enhanced prudential standards imposed by the Board of Governors under section 165 of the Dodd-Frank Act and with regulations providing for the early remediation of financial distress at the company under section 166 of the Dodd-Frank Act;¹¹³ and (3) file a written notice prior to acquiring voting shares of certain large financial companies.¹¹⁴ The Board of Governors is responsible for establishing the prudential standards that will be applicable to MetLife under section 165 of the Dodd-Frank Act. The Council's determination regarding MetLife does not provide the company with any new access to government liquidity sources or create any authority for the government to rescue the company in the event of its failure.

The Council has considered all the facts of record in light of the requirement that it consider the degree to which MetLife is already regulated by one or more primary financial regulatory

¹¹⁰ Each registered separate account is generally divided into subaccounts, each of which invests in an underlying mutual fund which is itself a registered investment company under the Investment Company Act of 1940. See MetLife Annual Report on Form 10-K for the year ended December 31, 2013, p. 26.

¹¹¹ *Id.*

¹¹² See Dodd-Frank Act section 165, 12 U.S.C. § 5365.

¹¹³ See Dodd-Frank Act sections 165 and 166, 12 U.S.C. §§ 5365, 5366. The enhanced prudential standards required by section 165 of the Dodd-Frank Act are for the purpose of "prevent[ing] or mitigat[ing] risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected financial institutions."

¹¹⁴ See Dodd-Frank Act section 163, 12 U.S.C. § 5363.

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agencies and has determined that the Dodd-Frank Act provides additional regulatory and supervisory tools focused on financial stability.

3.3 Resolvability

The Council also has considered whether the threat that material financial distress at MetLife could pose to U.S. financial stability could be mitigated or aggravated by its complexity, the opacity of its operations, or its difficulty to resolve. The Council has evaluated MetLife's resolvability, and the ease or difficulty of successfully separating and liquidating or otherwise disposing of the company if it should fail, in light of all the facts of record.

The Council recognizes that some insurance assets and businesses by their nature will take longer to wind down than others. Therefore, in the context of the phrase "rapid and orderly resolution" and as applied to these assets and businesses, the term "rapid" refers to the ability to timely implement a plan for resolving the company that calms markets and market participants. By design, the winding-down of a failed insurer's estate may take several years to accomplish while policyholder and contract holder liabilities are paid off as they come due, or are transferred to solvent insurers.

MetLife is a highly complex and interconnected financial services organization that operates in approximately 50 countries and provides services to approximately 100 million customers globally.¹¹⁵ The complexity of MetLife's operations and intercompany relationships, including intra-group dependencies for derivatives management, investment management, risk management, cross-border operations, and critical services, creates complexities that could pose obstacles to a rapid and orderly resolution.

MetLife's entities have a substantial number of interconnections to one another through intercompany funding arrangements, guarantees associated with inter-affiliate reinsurance, capital and net worth maintenance agreements, liquidity support commitments, and general account guarantees of separate account products that could transmit distress at one MetLife entity to other parts of the organization.¹¹⁶ These interconnections, along with MetLife's extensive and complex global network, could result in significant challenges to resolving the company.

MetLife's operations are subject to separate regulatory regimes administered by numerous state, federal, and non-U.S. regulators. There is no precedent for the resolution of an insurance organization of the size, scope, and complexity of MetLife. An effort to achieve a coordinated resolution of MetLife would require accommodations with each of its local supervisory authorities, as well as cooperation and coordination among a number of home and host jurisdiction supervisory authorities and courts. For example, if MetLife were to experience material financial distress, the resolution of its U.S. insurance subsidiaries would occur under the laws of the various state regulatory authorities in which it operates, and would involve various state GAs. An orderly resolution of MetLife would require the immediate and effective cooperation between various parties (e.g., bankruptcy courts and state courts) in order to avoid

¹¹⁵ MetLife, "MetLife in the World," available at

<https://www.metlife.com/assets/cao/iws/hp/about/MetLifeCorporateFactSheet.pdf> (accessed December 7, 2014).

¹¹⁶ See MetLife Annual Report on Form 10-K for the year ended December 31, 2013, pp. 151, 359-360.

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disruptions to the employees, facilities and infrastructure, and other services provided by these entities. Although state insurance regulators coordinate resolution through interstate associations and colleges, there is no single interstate regulator with jurisdiction across state boundaries. There is no global regulatory framework for the resolution of cross-border financial organizations, and applicable U.S. resolution regimes, including the separate state GAs, have never been tested by the resolution of an insurance organization of the size, scope and complexity of MetLife. These factors could aggravate the potential for MetLife's material financial distress, if it were to occur, to pose a threat to U.S. financial stability.

The interstate and cross-border complexities involved in resolving a large organization such as MetLife include the difficulty of ensuring the continuity of critical shared services, the separation of financial and operational linkages, the potential ring-fencing of assets, and the coordination of numerous receiverships and judicial proceedings across multiple jurisdictions. Multiple proceedings seeking to maximize recoveries for particular claimants could result in conflicts. Numerous receivers or judicial authorities would have to disentangle a complex web of intercompany agreements. A complex resolution process could increase the likelihood of delays in resolving claims and could result in increased losses.

Based on all the facts of record, the Council has determined that if MetLife were to experience material financial distress, issues related to its resolvability could aggravate the potential for its material financial distress to pose a threat to U.S. financial stability.

As noted above, the Council's determination regarding MetLife will enable the Board of Governors to apply a number of new requirements to MetLife, including a requirement that MetLife submit a resolution plan to the Board of Governors and the FDIC providing for its rapid and orderly resolution in the event of its material financial distress or failure. While a company's resolution can be complicated by its complexity, the opacity of its operations, or other exacerbating factors, the Council believes that no firm should be protected from its own failure, and these statutory tools enable regulators to facilitate the orderly liquidation of a company.

4. CONCLUSION

The Council has made a final determination that material financial distress at MetLife could pose a threat to the financial stability of the United States and that MetLife should be supervised by the Board of Governors and be subject to enhanced prudential standards.

December 18, 2014

Appendix A: MetLife Consolidated Balance Sheet

As of	
Sept. 30, 2014	
(\$ Millions, except share and per share data)	
ASSETS	
Investments:	
Fixed maturity securities available-for-sale, at estimated fair value	\$368,070
Equity securities available-for-sale, at estimated fair value	3,689
Fair value option and trading securities, at estimated fair value	17,246
Mortgage loans	58,038
Policy loans	11,756
Real estate and real estate joint ventures	10,393
Other limited partnership interests	8,214
Short-term investments, principally at estimated fair value	12,240
Other invested assets, principally at estimated fair value	17,905
Total investments	507,551
Cash and cash equivalents, principally at estimated fair value	8,783
Accrued investment income	4,380
Premiums, reinsurance and other receivables	23,814
Deferred policy acquisition costs and value of business acquired	25,503
Goodwill	10,216
Other assets	8,900
Separate account assets	319,480
Total assets	\$908,627
LIABILITIES AND EQUITY	
Future policy benefits	\$189,282
Policyholder account balances	215,226
Other policy-related balances	15,026
Policyholder dividends payable	710
Policyholder dividend obligation	2,825
Payables for collateral under securities loaned and other transactions	33,776
Short-term debt	100
Long-term debt	16,389
Collateral financing arrangements	4,196
Junior subordinated debt securities	3,193
Current income tax payable	293
Deferred income tax liability	11,357
Other liabilities	25,373
Separate account liabilities	319,480
Total liabilities	837,226
Redeemable noncontrolling interests	102
Total equity	71,299
Total liabilities and equity	\$908,627

Source: MetLife Quarterly Report on Form 10-Q for the quarter ended September 30, 2014, p. 4.

B HENSARLING, TX, CHAIRMAN

United States House of Representatives
 Committee on Financial Services
 Washington, D.C. 20515

MAXINE WATERS, CA, RANKING MEMBER

August 6, 2014

BY INTER-OFFICE AND ELECTRONIC MAIL

The Honorable Maxine Waters
 Ranking Minority Member,
 Committee on Financial Services
 2221 Rayburn House Office Building
 Washington, DC 20515

The Honorable Al Green
 Ranking Minority Member,
 Subcommittee on Oversight and Investigations
 2201 Rayburn House Office Building
 Washington, DC 20515

Dear Ranking Members Waters and Green:

We are in receipt of your recent letters requesting that the Subcommittee on Oversight and Investigations investigate allegations of discrimination at Goldman Sachs. As you know, such allegations are the subject of a pending civil law suit in the Southern District of New York (Case No. 10-6950) commenced in 2010, when Democrats controlled the House and this committee. We trust that the reason you elected not to investigate these matters when you controlled the House is because you believe, as we do, that Congress should not exercise its investigative prerogatives with respect to matters of fact and law that are currently being adjudicated in Federal court.

The Subcommittee's focus will remain on investigating credible allegations of discrimination at Federal agencies—which, unlike private businesses, Congress creates and thereby has an institutional responsibility to oversee—rather than interfering in pending litigation. We have a duty to demand accountability from those who have engaged in the reprehensible conduct as well as those who may have looked the other way, particularly where, as in the case of the CFPB whistleblowers who have come before the Subcommittee, the allegations of discrimination and retaliation have been independently corroborated. While our investigation to date has focused on serious allegations of discrimination, retaliation, and a toxic management culture at the Consumer Financial Protection Bureau, we reiterate our sincere offer to work with you to investigate any such similar allegations at any of the Federal financial regulators over which the Committee conducts oversight or, as was mentioned at last week's hearing, at the White House, which reportedly has some gender pay disparity issues of its own.

Hon. Maxine Waters
Hon. Al Green
August 6, 2014
Page 2

Thank you for your interest in and support of the Subcommittee's investigation into allegations of discrimination and retaliation at the CFPB. We are grateful that you have abandoned your earlier efforts to shut down the Subcommittee's investigation into such allegations at the CFPB, and we look forward to your continued partnership.

Sincerely,


JOB HENSARLING


PATRICK T. MCHENRY

METLIFE, INC.,
 Plaintiff,
 v.
 FINANCIAL STABILITY
 OVERSIGHT COUNCIL,
 Defendant.

Civil Action No. 15-cv-00045 (RMC)

Dated: May 22, 2015

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STATEMENT OF INTEREST

Amici are fifteen law and finance professors from leading universities whose research focuses on financial regulation and administrative law, including the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd–Frank”), Pub. L. No. 111-203, 124 Stat. 1376 (2010).¹ *Amici* have an interest in the presentation to the Court of analysis and academic research relevant to the issues in both fields raised by this case.

SUMMARY OF ARGUMENT

The financial crisis of 2008, and the deep and long recession that it spawned, were the most serious economic calamities to befall the nation since the Great Depression. Congress’s response, Dodd-Frank, recognized that the failure to effectively regulate nonbank financial companies was a central contributor to the crisis. The nation’s financial regulators had failed to foresee and address systemic risks, in part due to regulatory gaps that had prevented consolidated supervision by the Federal Reserve of major nonbank financial firms, such as Lehman Brothers and American International Group (“AIG”). To protect the country against future crises, Congress created the Financial Stability Oversight Council (“FSOC” or “Council”) and granted it the power to designate nonbank financial companies as systemically important financial institutions (“SIFIs”) subject to supervision by the Federal Reserve.² Without this power, nonbank financial firms could once again expose the nation to economic disaster. This grant of power is particularly important given that Congress simultaneously curtailed previously existing

¹ A list of *amici*—and their institutional affiliations, provided for identification purposes only—is included in the Appendix. Although several of the *amici* previously served in the current Administration, the views reflected here are solely their own.

² Although Dodd-Frank uses different language to describe firms that are designated by the FSOC, throughout this brief we adopt the common convention of referring to such firms as “SIFIs.”

emergency authorities that federal regulators used to stabilize nonbank financial firms during the crisis.

Congress carefully designed the FSOC's structure and procedures to ensure that SIFI designations would derive from expert, informed, and deliberate judgments. In order to produce system-wide perspective and deep expertise, Congress placed the heads of the nation's leading financial regulators on the FSOC. And to ensure deliberate and balanced decision-making in connection with SIFI designations, Congress imposed a supermajority voting requirement, included perspectives from independent and nonvoting members, and added numerous other internal procedural checks. At the same time, Congress understood—indeed, Congress mandated—that the FSOC's SIFI designations would be predictive in nature. The FSOC's role, Congress directed, would be to determine whether material financial distress at a nonbank firm *could* pose a threat to the financial stability of the United States, not whether it *would* constitute a threat. 12 U.S.C. § 5323(a) (2012). That is because the very purpose of designation is to subject the firm to consolidated supervision by the Federal Reserve so that regulators can prevent the firm from undermining the nation's economic stability in the future.

Anticipating that the Council's work would demand deep expertise and probabilistic judgments and be subject to procedural protections that ensure informed and deliberate decision-making, Congress expressly limited judicial review of FSOC designations. *See* 12 U.S.C. § 5323(h) (2012). This Court's review in this case is statutorily restricted to the highly deferential arbitrary and capricious standard, and FSOC's designation of MetLife easily meets that standard. MetLife's designation was based on two projected threats to financial stability that could arise from the company's material financial distress: losses caused by financial-market participants' exposure to MetLife and market disruptions arising from the asset sales that could accompany

MetLife's distress. Far from being arbitrary or capricious, both projections were carefully reasoned and are amply supported by the record.

In the end, MetLife's challenge amounts to an effort to have this Court impose procedural and evidentiary prerequisites on FSOC designations that are not found in the governing statute. But those policy choices are for Congress, not the courts. This Court should decline MetLife's invitation to interfere with Congress's policy choices about how best to secure the stability of the U.S. economy.

ARGUMENT

I. IN RESPONSE TO THE DEVASTATING EFFECTS OF NONBANKS' DISTRESS DURING THE 2008 FINANCIAL CRISIS, CONGRESS CREATED A CAREFULLY BALANCED SYSTEM FOR IDENTIFYING SYSTEMICALLY SIGNIFICANT NONBANK FINANCIAL FIRMS.

A. In Dodd–Frank, Congress Recognized that Regulatory Gaps Leading to the Absence of Effective Federal Supervision of Nonbank Financial Firms Contributed to the Crisis.

The financial crisis of 2008 crushed the American economy, plunging the United States into a years-long Great Recession. The crisis shuttered American businesses, cost millions of Americans their jobs, and wiped out billions in home values and retirement savings. S. Rep. No. 111-176, at 39 (2010); *see also* Fin. Crisis Inquiry Comm'n, *The Financial Crisis Inquiry Report* xv–xvi (2011). This wreckage arose, in part, from the activities of firms outside the formal banking system that were nevertheless engaged in extensive financial activities. S. Rep. No. 111-176, at 40, 43. These firms effectively engaged in the essential business of banks—including “maturity transformation,” or borrowing in the short term and lending over the long term—but escaped meaningful prudential regulation. When the short-term funding markets that these firms relied upon dried up, their distress fanned a panic that nearly destroyed the global financial system.

The regulatory gaps that allowed these firms to evade federal oversight contributed significantly to the crisis and the harm that it caused. According to Congress, “gaps in the regulatory structure allowed . . . risks and products to flourish outside the view of those responsible for overseeing the financial system,” with “[m]any major market participants . . . not subject to meaningful oversight by federal regulators.” S. Rep. No. 111-176, at 43. These participants included major nonbank financial companies like AIG and Lehman Brothers. *Id.*

To address the regulatory gaps revealed by the nation’s experience with AIG and Lehman, Congress created the FSOC and gave it authority to designate nonbank financial firms for Federal Reserve supervision. Unlike other federal financial regulators, whose reach is limited to specified activities or markets, Congress gave the FSOC the unique ability to “get above [other regulators’] silo-like focus, so they can look ahead of the crisis.” 156 Cong. Rec. 6615 (2010) (statement of Sen. Warner). Designation, in turn, ensured that major market participants with the potential to wreak havoc on the U.S. economy would no longer be able to evade effective federal oversight.

B. Congress Designed the FSOC’s Structure and Procedures to Ensure that Its SIFI Designations Derive from Expert, Informed, and Predictive Judgments About the Financial System.

Congress carefully designed the FSOC’s structure and procedures to ensure that its SIFI designations would be the product of an expert, informed, and deliberative process. At the same time, Congress anticipated that the FSOC’s judgments would be predictive in nature. Congress understood that the FSOC—by the very nature of its responsibility for identifying nonbank firms that could contribute to the next crisis if not properly supervised—would be required to make predictions about how such firms’ distress could pose a threat to financial stability.

1. Congress Designed the FSOC's Structure and Procedures to Ensure Expert, Informed, and Constrained Exercise of the Designation Power.

While debating and enacting Dodd–Frank, Members of Congress repeatedly recognized the vast and changing nature of the financial system—and the complexity of analyzing systemic risk. *See, e.g., Modernizing Bank Supervision and Regulation—Part 1: Hearing Before the S. Comm. on Banking, Hous. & Urban Affairs*, S. Hrg. No. 111-109, 111th Cong. 2 (2009) (statement of Sen. Dodd). Precisely because of this complexity, Congress created the FSOC: A uniquely expert body with significant discretion to “identify risks to the financial stability of the United States” and to “respond to emerging threats to the stability of the United States financial system.” 12 U.S.C. § 5322(a)(1) (2012).

The FSOC’s voting members include all of the nation’s top financial regulators, each the head of an agency charged with overseeing a class of financial institutions or activities, and an independent member with insurance expertise, as well as the Secretary of the Treasury as Chair. *See* 12 U.S.C. § 5321(b)(1). The Council also has nonvoting members who serve in an advisory capacity. *Id.* § 5321(b)(2). This structure builds into the FSOC deep knowledge of financial institutions across the economy, as well as competing perspectives and viewpoints.³ The FSOC’s composition resembles other administrative entities that have similarly weighty responsibilities—such as the National Security Council, charged with responsibility for advising the President on crucial matters of national security. 50 U.S.C. § 3021(a)–(b) (Supp. I 2013).

The FSOC’s structure reflects Congress’s deliberate effort to create a systemic financial regulator that would combine the expertise and diverse perspectives of distinct prudential regulators into a single, coordinated body. The Obama Administration initially proposed

³ *See* Jacob E. Gersen, *Administrative Law Goes to Wall Street: The New Administrative Process*, 65 Admin. L. Rev. 689, 693–702 (2013).

creating an oversight council with only monitoring, coordinating, and advisory functions, while providing the Federal Reserve the authority to designate nonbank financial firms.⁴ The proposal of a council with relatively limited powers triggered criticism at congressional hearings: Members of Congress and many witnesses urged that, to predict and protect against the next financial crisis, the council needed to have greater regulatory bite.⁵

In the end, Congress determined that the designation power should lie with a body capable of looking across the sweep of the entire financial system. Following the advice of leading financial regulators that the designation authority reflected “tremendous power” and was thus “better exercised by a council where there would be a diversity of views and some checks and balances,” Congress included the heads of all major financial regulatory agencies on the Council.⁶ Congress also guarded against arbitrary decision-making by imposing a supermajority voting requirement for SIFI designations. Such designations can only be made “on a nondelegable basis and by a vote of not fewer than 2/3 of the voting members then serving,” including an affirmative vote by the Treasury Secretary. 12 U.S.C. § 5323(a)(1).⁷ In sum, Congress made near consensus among a group of financial regulators and experts with an unprecedented diversity of perspectives a prerequisite to exercise of the FSOC’s designation authority. Congress also imposed notice and hearing requirements on SIFI designations, 12

⁴ See *Establishing a Framework for Systemic Risk Regulation: Hearing Before the S. Comm. on Banking, Hous. & Urban Affairs*, S. Hrg. No. 111-297, 111th Cong. 2–3 (2009) (statement of Sen. Dodd); *The Administration’s Proposal to Modernize the Financial Regulatory System: Hearing Before the S. Comm. on Banking, Hous. & Urban Affairs*, S. Hrg. No. 111-228, 111th Cong. 7 (2009) (statement of Timothy Geithner, Secretary, Dep’t of the Treasury).

⁵ See *Establishing a Framework for Systemic Risk Regulation, supra*, at 8–9 (statement of Mary L. Schapiro, Chairman, SEC); *id.* at 13–14 (statement of Sheila C. Bair, Chairman, FDIC); *id.* at 40 (statement of Sen. Warner).

⁶ See *id.* at 17 (statement of Sheila C. Bair, Chairman, FDIC).

⁷ The legislative history reveals that Congress chose this procedure deliberately: The initial House version of the bill provided for SIFI designations by a simple majority vote. See H.R. 4173, 111th Cong. § 1103(a) (Dec. 2, 2009).

U.S.C. § 5323(e), and required the FSOC to consult with any nonbank company's prudential regulator before determining whether the company should be subject to Federal Reserve supervision and to annually reevaluate its designation. *Id.* §§ 5323(d), (g).

2. *Both Congress and the FSOC Recognized that SIFI Designations Would Necessarily Involve Predictive Analysis.*

Having designed an expert institution with a unique range of regulatory perspectives and extensive internal checks and balances, Congress made clear that the FSOC would often need to make predictive judgments in designating SIFIs. *See, e.g.*, 156 Cong. Rec. 6919 (2010) (statement of Sen. Dodd); 155 Cong. Rec. 30,828 (2009) (statement of Rep. Kanjorski) (Dodd-Frank allows designation for nonbanks “that are so large, interconnected, or risky that their collapse would put at risk the entire American economic system, even if those firms currently appear to be well-capitalized and healthy.”).

The text of Dodd-Frank is clear that the designation process will involve a predictive judgment, authorizing the FSOC to designate nonbank financial companies whose distress “*could* pose a threat to the financial stability of the United States.” 12 U.S.C. § 5323(a)(1) (emphasis added). More generally, Congress described the duties of the Council to include “requir[ing] supervision . . . for nonbank financial companies that *may* pose risks to the financial stability of the United States.” *Id.* § 5322(a)(2)(H) (emphasis added). Notably, Congress did not require the FSOC to show that a designated firm’s distress *would* pose a threat to financial stability, although Congress did impose that evidentiary burden as a condition for other regulatory actions authorized by Dodd-Frank.⁸

⁸ *See, e.g.*, Dodd-Frank § 722(h) (amending the Commodity Exchange Act, 7 U.S.C. § 1b, to permit the Secretary of the Treasury to exempt foreign exchange contracts from Dodd-Frank’s swaps-clearing mandate only after the Secretary considers, *inter alia*, “whether the required trading and clearing of [those contracts] *would* create systemic risk . . . or threaten the financial

It is unsurprising that Congress chose conditional, predictive language when describing the standard for SIFI designations. Assessing the systemic effects of distress at large financial firms requires regulators to forecast how millions of market participants might respond to the news that a major market participant may not be able to meet its obligations. The agency must then in turn predict how market participants might respond to *other participants'* reactions to this information.⁹ Moreover, the regulator must conduct this assessment for a broad range of potential states of the world: Those where the institution's failure leads to cascading failures of other institutions, for example, as contrasted with those where the institution's failure stands alone. That is why Congress required that FSOC show only that a nonbank firm's distress "*could* pose a threat to the financial stability of the United States" in order to designate that firm for Federal Reserve supervision. Consistent with Congress's direction, the Council's designation process anticipates that the analysis underlying a designation will be predictive and enables the FSOC to consider a wide range of data and analyses before reaching its decision.¹⁰

stability of the United States" (emphasis added)). The Treasury Department has already issued an exemption for foreign exchange contracts under this provision, and it was careful to describe its evidentiary basis in the terms Congress required. Determination of Foreign Exchange Swaps and Foreign Exchange Forwards under the Commodity Exchange Act, 76 Fed. Reg. 25,774, at 25,775, 25,777 (May 5, 2011) (finding that these contracts "*would* mitigate the relevant risks" and that "requiring clearing [of the contracts] *would* disrupt the existing settlement process" (emphases added)).

⁹ Congress's recognition of the predictive nature of the designation process is consistent with recent academic literature emphasizing the dynamic nature of financial regulation as a limit on what agencies can and should be required to know before making regulatory choices. See, e.g., John C. Coates IV, *Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications*, 124 Yale L.J. 882, 1011 (2015); Jeffrey N. Gordon, *The Empty Call for Cost-Benefit Analysis in Financial Regulation*, 43 J. Legal Stud. (Special Issue) 351, 366–67 (2014).

¹⁰ See Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. 21,637, 21,645 (Apr. 11, 2012) (codified at 12 C.F.R. pt. 1310) (requiring the Council to conduct "robust analysis of the *potential* threat that . . . nonbank financial companies *could* pose to U.S. financial stability" and allowing it to consider "information obtained directly from the nonbank financial company"); Fin. Stability Oversight Council, *Supplemental Procedures Relating to Nonbank Financial Company Determinations* 2-3

C. The FSOC's Designation Authority Is Particularly Important in Light of Restrictions Congress Has Imposed on Strategies that Federal Regulators Used During the 2008 Financial Crisis.

At the same time that Congress gave the FSOC significant power to anticipate and prevent future financial instability through the SIFI designation process, Congress also limited the tools that federal financial regulators had used in 2008 to address the financial crisis. As a result, impairment of the FSOC's designation authority would not only create a gap in the federal government's ability to anticipate future financial crises—it would do so at a time when financial regulators have fewer tools at their disposal to remediate failure.

For example, in the days following Lehman's bankruptcy in 2008, the Federal Reserve lent billions of dollars that provided critical liquidity to AIG to prevent a nonbank failure that would have devastated the U.S. economy. Fin. Crisis Inquiry Comm'n, *supra*, at 347–52. Dodd–Frank, however, curtails the Federal Reserve's authority to lend to individual firms in this way. 12 U.S.C. § 343(3)(A). Similarly, the failure of another systemically significant nonbank company, Bear Stearns, in early 2008 presaged the financial crisis that followed. That firm's orderly acquisition by J.P. Morgan was made possible by emergency Federal Reserve lending to an entity that acquired toxic assets then held by Bear Stearns. Fin. Crisis Inquiry Comm'n, *supra*, at 289–90. But the Federal Reserve's authority to take similar actions in the future was significantly constrained by Dodd–Frank. *See* 12 U.S.C. §§ 343(3)(A), 343(3)(B)(iv), (C) (requiring any such lending to be “broad-based,” rather than transactional, and requiring approval from the Secretary of the Treasury and disclosure to Congress in the event that the Federal Reserve engages in such lending).

(2015) (permitting companies potentially subject to designation to submit written materials to the FSOC).

In sum, Congress chose to replace many of the authorities that federal regulators used in 2008, which targeted the *ex post* implications of nonbank firm failures, with the FSOC and its power to identify nonbank firms for regulatory scrutiny *ex ante*. Congress thereby made the FSOC's SIFI designation authority critical to ensuring the nation's economic stability.

II. CONGRESS LIMITED JUDICIAL REVIEW OF FSOC SIFI DESIGNATIONS TO A HIGHLY DEFERENTIAL ARBITRARY AND CAPRICIOUS STANDARD, WHICH IS EASILY MET HERE.

The statutory system that Congress created to protect the nation's economic stability thus depends on expert and predictive judgments collectively reached by the nation's top financial regulators. Although Congress provided for judicial review of SIFI designations, it made clear that the courts should play a limited role. The highly deferential arbitrary and capricious standard Congress established for SIFI designations is easily met here. The FSOC's designation of MetLife was carefully considered and well-reasoned, and its explanation for MetLife's systemic financial importance is amply supported by the record and by academic research.

A. Congress Limited Judicial Review of FSOC SIFI Designations to a Highly Deferential Arbitrary and Capricious Standard.

In providing the FSOC with its critical authority to designate nonbank financial companies as SIFIs, Congress specified that judicial review of the FSOC's SIFI designations would be "limited to whether the final determination . . . was arbitrary and capricious." 12 U.S.C. § 5323(h) (2012). Such review, it has long been established, is "narrow" and very deferential to the agency's conclusions. *Motor Vehicle Mfrs. Ass'n of the U.S. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983); *see also Rural Cellular Ass'n v. FCC*, 588 F.3d 1095, 1105 (D.C. Cir. 2009). As the Supreme Court has explained, "[a] court is not to substitute its judgment for that of the agency." *State Farm*, 463 U.S. at 43. Rather, agency action is

normally “entitled to a presumption of regularity.” *Citizens to Pres. Overton Park, Inc. v. Volpe*, 401 U.S. 402, 415 (1971).

While arbitrary and capricious review is always deferential, it is even more so here for four reasons. *First*, “the decision under review requires expert policy judgment of a technical, complex, and dynamic subject.” *Cablevision Sys. Corp. v. FCC*, 597 F.3d 1306, 1311 (D.C. Cir. 2010). As the D.C. Circuit has long held, “[a]gency determinations based upon highly complex and technical matters” are entitled to great deference. *Domestic Sec., Inc. v. SEC*, 333 F.3d 239, 248 (D.C. Cir. 2003) (quoting *Appalachian Power Co. v. EPA*, 251 F.3d 1026, 1035 (D.C. Cir. 2001)) (internal quotation marks omitted). Few agency decisions are more technical, or involve more complex economic judgments, than the FSOC’s task of determining whether “material financial distress at the U.S. nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the U.S. nonbank financial company, could pose a threat to the financial stability of the United States.” 12 U.S.C. § 5323(a)(1).

Second, particularly deferential review is warranted here because the judgment under review is fundamentally predictive in nature. *See Rural Cellular Ass’n*, 588 F.3d at 1105. “In circumstances involving agency predictions of uncertain future events, complete factual support in the record for the [agency’s] judgment or prediction is not possible or required.” *Id.* (quoting *Melcher v. FCC*, 134 F.3d 1143, 1151 (D.C. Cir. 1998)) (internal quotation marks omitted). This is because “a forecast of the direction in which future public interest lies necessarily involves deductions based on the expert knowledge of the agency.” *Id.* (quoting *Melcher*, 134 F.3d at 1151) (internal quotation marks omitted); *see also BellSouth Corp. v. FCC*, 162 F.3d 1215, 1221 (D.C. Cir. 1999) (quoting *Melcher*, 134 F.3d at 1152) (“When . . . an agency is

obliged to make policy judgments where no factual certainties exist or where facts alone do not provide the answer, our role is more limited; we require only that the agency so state and go on to identify the considerations it found persuasive.”).

Third, judicial review is only one of the many mechanisms that Congress used to guard against arbitrary SIFI designations. Congress carefully designed the FSOC to be a broadly expert body, one that would harness the major financial regulatory agencies’ deep area-specific expertise into a single Council that would be free of parochial bias and able to identify threats to the financial system as a whole. The FSOC’s unusual structure and design, as well as its voting procedures, ensure that SIFI determinations are informed by extensive financial expertise, incorporate diverse regulatory perspectives, and reflect supermajority support among the nation’s leading financial regulators.

Fourth and finally, Congress’s choice to limit judicial review of SIFI designations contrasts strikingly with its approach in other financial regulatory contexts, such as that of the Securities and Exchange Commission (“SEC”). There the D.C. Circuit has held that statutory language obliging the SEC to consider “the effect of a new rule upon efficiency, competition, and capital formation,” 15 U.S.C. §§ 78c(f), 78w(a)(2), 80a-2(c), imposes a “*unique obligation*” on the agency’s evidentiary burden before the courts. *Business Roundtable v. SEC*, 647 F.3d 1144, 1148 (D.C. Cir. 2011) (emphasis added). Here, Congress imposed no such obligation, instead charging the FSOC with using its expert judgment to examine the potential for a particular company to threaten the financial stability of the United States based on a range of factors, with its ultimate determination subject only to “arbitrary and capricious” review. 12 U.S.C. § 5323(h).

B. The FSOC's Designation of MetLife Easily Meets the Deferential Standard of Review Applicable Here.

The FSOC's determination that material financial distress at MetLife could pose a threat to the financial stability of the United States easily survives the deferential arbitrary and capricious standard of review applicable here. The FSOC provided two bases for its determination. First, it concluded that both institutional and retail financial-market participants' exposures to MetLife could cause material financial distress at MetLife to threaten U.S. financial stability. Second, it found that asset liquidations resulting from MetLife's financial distress could also pose such a threat. Both of these bases are amply supported by the record in this case. They are also supported by broader academic research. Moreover, they reflect exactly the sort of expert judgment that Congress charged the FSOC with making. Indeed, the objections that MetLife is attempting to litigate here demonstrate the importance of great deference to the nation's sole regulatory body with a view of the full sweep of financial markets.

1. The FSOC Properly Concluded that MetLife's Financial Distress Could Threaten U.S. Financial Stability Through Market Participants' Significant Exposure to MetLife.

Institutional investors. The Council found that large financial institutions—the pension funds, money market funds, large banks, and large insurers that are critical to so many financial markets—have significant exposures to MetLife both because of MetLife's role as a guarantor of investments throughout the economy and because of MetLife's own capital-market activities.

As to MetLife's role as a guarantor, the Council's analysis shows that the company directly or indirectly guarantees the value of more than \$100 billion of investments for large institutions. *See* Fin. Stability Oversight Council, *Notice of Final Determination and Statement of the Basis for Financial Stability Oversight Council's Final Determination Regarding MetLife*,

Inc. 11–12, 75–76 (Dec. 18, 2014) [hereinafter Final Basis¹¹] (describing and quantifying MetLife guarantees). MetLife thus provides institutional investors with critical protection in the event of a significant drop in their investments’ value. If MetLife were to experience material financial distress, this important backstop would be compromised, leading to broader financial instability. *See id.* at 86 (stating that although “a large portion of MetLife’s institutional products are in separate accounts,” “the guarantees for these products are obligations of the general account and therefore reliant on MetLife’s financial strength”). The consequences of such instability could be significant because material financial distress at MetLife is unlikely to occur in a vacuum. Rather, distress at MetLife is likely to occur in the context of broader market stress—at the very moment when institutional investors and their fiduciaries would most be in need of MetLife’s guarantees.

The record equally supports the FSOC’s conclusions regarding institutional exposures to MetLife’s capital markets activities. As the FSOC found, institutional investors will suffer greatly if MetLife is unable to repay what it has borrowed. Institutional investors, large financial institutions and others own more than \$130 billion of MetLife’s debt.¹² It is clear that MetLife’s failure would impose losses on these investors that could pose a threat to the financial stability of the United States.

Even more striking than the aggregate size of MetLife’s debt is that MetLife finances so much of its activities through short-term borrowing that must be repaid or refinanced in the near

¹¹ This brief cites the previously non-public Final Basis, which was provided to undersigned *Amici* by the FSOC on May 13, 2015, with redactions that had been made by MetLife.

¹² *See id.* at 98 & tbl. 8 (summarizing MetLife’s financing structure). This figure was calculated by taking the total amount of capital-market exposure to MetLife described in Table 8 of the Final Basis and deducting MetLife’s market capitalization as of June 30, 2013, the date of the data provided in that Table. Thus, the figure includes certain contingent liabilities included in the values described in Table 8.

term. *See id.* at 101 & tbl. 9 (classifying only \$18.6 billion of MetLife’s \$56.1 billion in debt as “long-term” debt). Such short-term borrowing is commonly financed by money-market funds (“MMFs”), and the FSOC’s analysis shows that MMFs hold more than \$4 billion in MetLife’s short-term borrowings. *See id.*, at 110 & tbl. 13. MMF investors view MMFs as a low-risk investment and rely heavily on their ability to redeem their MMF shares for no less than one dollar per share at any time.¹³ But the FSOC found that, should MetLife experience material financial distress, anywhere from eleven to as many as *sixty-five* MMFs could “break the buck” and go below that critical one dollar per share level. *See id.* at 111 & fig. 6 (showing that, as of 2013, sixty-five MMFs could break the buck if MetLife’s debt securities lost 100% of their value, and that eleven funds could do so if MetLife’s debt securities lost just 15% of their value).

This finding is notable for two reasons. *First*, it is eerily familiar: In 2008, the failure of a nonbank financial firm to which MMFs had provided short-term lending—in that case, Lehman Brothers—led to fear that MMFs might “break the buck,” contributing to a broad panic among investors, who withdrew \$300 billion from MMFs in the days following Lehman’s bankruptcy.¹⁴ That panic, or “run,” on MMFs resulted in significant instability throughout the financial system, and helped to freeze credit markets for financial and real-economy firms alike. The run was stopped only by an unprecedented, multi-trillion-dollar government guarantee on MMFs, which dwarfed better-known efforts like the Troubled Asset Relief Program in size and scope. *Second*, as recent scholarship in this area has noted, tepid post-crisis attempts to reform MMFs provide

¹³ *See, e.g.*, Richard Scott Carnell, Jonathan R. Macey & Geoffrey P. Miller, *The Law of Banking and Financial Institutions* 604–10 (4th ed. 2009) (describing MMFs as a functional “substitute” for federally insured checking accounts); *see also* Marcin Kacperczyk & Philipp Schnabl, *How Safe Are Money Market Funds?*, 128 Q.J. Econ. 1073, 1074 (2013) (noting that, before the 2008 financial crisis, “investors regarded money funds as a low-risk investment that was almost as safe as cash”).

¹⁴ *See, e.g.*, Kacperczyk & Schnabl, *supra*, at 1.

little assurance that such a run could not occur again.¹⁵ The record thus supports FSOC's conclusion that material financial distress at MetLife could threaten the stability of the U.S. financial system through institutional investor exposures.

Retail customers. The record also supports the FSOC's conclusion regarding retail customers. MetLife has more than fifty million U.S. insurance customers and over \$275 billion in general account insurance liabilities. Should MetLife face material distress, these customers would face the unprecedented possibility that their insurer, one of the nation's largest, would be unable to meet policyholder demands for cash.

Legal and economic barriers that deter policyholders from surrendering their policies for cash, or borrowing against their policies, could mitigate the strain on *MetLife's* resources in the event of its distress, as MetLife contends. Compl. 28–30. But it does not follow that these barriers would limit or avoid the *systemic* consequences of MetLife's inability to meet policyholders' demands for cash.¹⁶ To the contrary, policyholders who face the possibility that MetLife might fail, and who cannot easily exchange claims on MetLife for cash, can be expected to seek other sources of liquidity at precisely the moment when the financial system is under stress. Nor should we expect policyholders simply to be able to substitute into insurance products provided by MetLife's competitors under the extraordinary circumstances that would accompany MetLife's distress. As the FSOC concluded, distress at a firm of MetLife's size and

¹⁵ See Jeffrey N. Gordon & Christopher M. Gandia, *Money Market Funds Run Risk: Will Floating Net Asset Value Fix the Problem?*, 2014 Colum. Bus. L. Rev. 313, 326–29 (providing empirical evidence suggesting that the SEC's principal reforms in this area are unlikely to address some causes of the 2008 MMF panic).

¹⁶ Nor, as the Council concluded, does it follow that these economic barriers will prevent many policyholders from surrendering their policies in sufficiently uncertain circumstances. Final Basis, *supra*, at 169 (“Depending on the circumstances, the unknown costs of retaining a policy could be larger than the known costs of surrendering a policy.”).

scope could lead consumers to doubt the “financial strength . . . of the broader industry.” Final Basis, *supra*, at 91.

MetLife maintains that any systemic consequences of its inability to meet policyholder cash demands could be mitigated by state guaranty associations (“GAs”)—*i.e.*, entities funded by assessments on insurance policies that cover benefit payments in the case of an insurer’s failure. But a failure of an insurer of MetLife’s vast size would test the limits of the GAs’ financial and operational resources, exposing policyholders to losses beyond those limits.

As to the GAs’ capacity to cover the full financial scope of policyholders’ exposure, as the FSOC correctly pointed out the amount of coverage GAs provide to policyholders varies a great deal by policy type, ranging from as little as \$100,000 to as much as \$500,000. *See* Final Basis, *supra*, at 89 n.452. In some cases, therefore, GAs would not cover all losses. And even if the GAs could and did cover all policyholder losses arising from distress at MetLife, their resources could be so depleted as to leave them unable to respond to losses were another insurer to fail—again, at the precise moment when such a failure might be most likely. *See id.* at 94 (“MetLife’s liquidation could leave the GAs with little capacity to respond to the failure of other large or mid-size insurers.”).

More importantly, it is doubtful that the various state GAs have the operational capacity to handle distress at a firm of MetLife’s scale and scope. The GAs would have to manage a situation of dazzling complexity involving the resolution of dozens of insurance subsidiaries. True, the National Organization of Life and Health Insurance Guaranty Associations (“NOLHGA”), a voluntary association of state GAs, historically has coordinated resolution efforts among the GAs. *See* Compl. 30. But each state GA participates in such a resolution on a

voluntary basis, and the NOLHGA has never attempted to coordinate a resolution in the context of distress at a firm of MetLife's size and scope. *See* Final Basis, *supra*, at 90.

In any event, the relevant question here is not whether the NOLHGA could actually manage such a spectacular and unprecedented resolution, but whether policyholders, in the midst of the crisis-like atmosphere that would likely accompany a MetLife failure, might fear that state GAs' resolution efforts would be inadequate to prevent losses. That fear could lead policyholders to demand safety and liquidity at a time when the financial system is bereft of both, threatening the stability of the U.S. financial system. The Council's conclusion that retail policyholders might respond to MetLife's failure—and the cascading uncertainty that would follow—in this way was neither arbitrary nor capricious.

2. *The FSOC Properly Found that MetLife's Material Financial Distress Could Lead to Asset Sales that Could Threaten U.S. Financial Stability.*

The record also provides ample support for the FSOC's finding that financial distress at MetLife could lead to "fire sales" of its assets—*i.e.*, rapid sales at increasingly lower prices to generate cash—that would threaten systemic stability. The FSOC correctly found that asset sales related to both MetLife's funding structure and its policyholder obligations could pose such a threat.

Funding structure. As noted above, *see supra* Part II.B.1., MetLife engages extensively in maturity transformation, borrowing in the short term and lending over the long term. As a result, MetLife lacks the flexibility to respond to sudden repayment demands without engaging in extensive asset sales. MetLife would face such repayment demands if the institutions that provide its short-term financing refuse to "roll over" or extend the repayment of MetLife's

borrowing.¹⁷ This refusal could drain more than \$5 billion in cash each month from the company. Final Basis, *supra*, at 152 & tbl.23.¹⁸ In addition, MetLife extensively lends highly liquid securities (*i.e.*, those that can quickly be sold for cash) to other institutions, receiving cash that it invests in illiquid securities (*i.e.*, those that are more difficult to sell). In ordinary circumstances, this is a common, and highly profitable type of trade conducted by many large financial institutions. In the event of MetLife's distress, however, the borrowers of its securities could demand that their cash be returned. To make things worse, once financial distress at MetLife is detected, its short-term lenders will become increasingly unwilling to roll over its debt and borrowers of its securities will increasingly demand that their cash be returned. These events could lead to additional asset sales that would depress securities prices, further threatening the stability of the financial system.¹⁹

Policyholder obligations. As explained above, *see supra* Part II.B.1, MetLife's financial distress could lead policyholders to doubt whether the company will be able to meet its obligations, and hence cause them to surrender their policies for cash. Notwithstanding legal and economic impediments to such surrenders, some \$50 billion in MetLife policyholder obligations can be withdrawn with little or no penalty over a relatively short period of time. Final Basis, *supra*, at 143. MetLife may need to sell additional assets to meet policyholder demands for cash.

¹⁷ See, e.g., Viral Acharya et al., *Rollover Risk and Market Freezes*, 66 J. Fin. 1177 (2011) (providing a framework for analysis of the risk that short-term borrowing will not be rolled over).

¹⁸ Indeed, as the FSOC found, MetLife was unable to roll over the most favorable form of its short-term borrowings during the financial crisis. See Final Basis, *supra*, at 153 & fig.7 (showing that MetLife addressed this problem in 2008 by borrowing over an increasingly shorter term and by borrowing on financial terms that were increasingly favorable to its lenders).

¹⁹ Because of MetLife's size and the illiquid nature of many of its assets, such sales would significantly affect the prices of these securities. See Final Basis, *supra*, at 151 & n. 736 (citing Brian Begalle et al., *The Risk of Fire Sales in the Tri-Party Repo Market*, FRBNY Staff Report No. 616 (2013), for the proposition that sales of more than \$250 million would impact prices in these markets).

To be sure, as MetLife has pointed out, state insurance regulators can impose stays on policyholder redemptions that would give MetLife precious time to meet these demands. Compl. 29, 59–60. But the imposition of such a stay would send a powerful signal about the magnitude of MetLife’s distress that could cause still more policyholders to seek to surrender their policies for cash.²⁰ See Final Basis, *supra*, at 144–45 (pointing out that “the imposition of a stay on discretionary withdrawals could cause a loss of confidence”).

Moreover, the critical point again is that the demands on MetLife’s cash in a crisis can all be expected to occur *at the same time*. In the event of its distress, MetLife’s short-term lenders will likely extend less credit, its securities-lending counterparties will likely require that cash be returned, and its policyholders will likely demand more cash than under any other circumstances. They will do so not only because of their awareness of MetLife’s weakness but because of concerns about how other institutions will respond to MetLife’s weakness. Under these circumstances, MetLife could well be forced to liquidate assets at a magnitude and speed that could threaten financial stability. The Council’s finding to that effect was neither arbitrary nor capricious.

C. This Court Should Decline MetLife’s Invitation to Impose Procedural or Evidentiary Requirements Beyond Those Contemplated by Congress.

MetLife’s challenge to its designation essentially recognizes that the FSOC acted neither arbitrarily nor capriciously in making its predictive judgment. Instead, it attacks the very statutory scheme for addressing systemic risk that Congress created. Indeed, MetLife not only

²⁰ Imposing a stay on policyholder demands for cash is akin to the old policy of declaring a “bank holiday,” barring depositors from withdrawing their savings from a bank that is in danger of suffering a run. It is true that such holidays gave individual banks badly needed breathing room to address potential runs. But the practice also fanned widespread banking panics and contributed to the Great Depression. No one seriously argues today that bank holidays are a useful or wise policy tool for preventing bank runs.

evades the fact that Congress instructed FSOC to make the predictive judgments it did, but also seeks to impose procedural and evidentiary prerequisites on the FSOC that are not found in the governing statute. But it is well established that these types of policy choices are left to Congress, not the courts.

We focus here on just two of MetLife's many contentions that improperly invite the Court to engage in policy choices better left to Congress and the FSOC. *First*, MetLife suggests that the Court require that FSOC determinations meet procedural requirements not specified by Congress in Dodd-Frank. *Second*, MetLife urges the Court to second-guess the predictive analysis upon which its designation is based. The Court should decline both invitations to make financial regulatory policy. Doing otherwise would seriously impede the Council's ability to discharge its critical task of safeguarding the nation's financial stability.

Procedural requirements. As noted above, in Dodd-Frank Congress carefully established both the FSOC and the procedural safeguards associated with the designation process, including supermajority voting requirements, the right to a hearing, and a requirement that the FSOC engage in regulatory consultation. *See supra* Part I.A. In addition, the Council has separately established and expanded upon the procedural protections that nonbank financial firms enjoy in connection with the designation process, including the right to make voluntary submissions for the Council's consideration before a proposed designation. *See id.*

MetLife, however, argues that a better approach is reflected in the Federal Reserve Board's bank "stress tests," or comprehensive capital analysis and review process ("CCAR"). *See* Compl. 53–54. According to the Complaint, the CCAR process employs "specific quantitative variables"; by contrast, MetLife contends, the FSOC's designation process is a "black box." *Id.* at 54.

Nothing in law or logic requires the FSOC to adopt rigid quantitative measures in connection with the designation process.²¹ Congress specified not only the procedural prerequisites to designation but also the factors that should guide the Council, including the extent of the company's leverage, its interconnections with other SIFIs, and "any other risk-related factors that the Council deems appropriate." 12 U.S.C. § 5323(a)(2)(K). Congress chose not to require that the Council establish particular quantitative measures in connection with the designation process. Moreover, Congress's choice reflects sound policy. As noted above, the complex and dynamic nature of systemic-risk analysis often renders quantitative measures unduly narrow or even misleading in this context.

Thus, both the statutory text and policy rationale of Dodd-Frank make clear that consideration of any factors beyond those expressly listed in the statute is left to the FSOC, not the courts. As a result, this Court lacks authority to impose such tests as a prerequisite to SIFI designation. Just this Term the Supreme Court reiterated the cardinal principle of administrative law that courts must not impose additional procedures on agencies beyond those that are otherwise required by law. *See Perez v. Mortg. Bankers Ass'n*, 135 S. Ct. 1199, 1207 (2015) ("Beyond the APA's minimum requirements, courts lack authority to impose upon [an] agency its own notion of which procedures are 'best' or most likely to further some vague, undefined public good. . . . To do otherwise would violate the very basic tenet of administrative law that agencies should be free to fashion their own rules of procedure." (quoting *Vt. Yankee Nuclear Power Corp. v. NRDC*, 435 U.S. 519, 544, 549 (1978)) (internal quotation marks omitted)).

²¹ For present purposes, we put to one side the fact that the Council actually *has* chosen, in its discretion, to employ clearly articulated quantitative measures at Stage 1 of the designation process. *See* 77 Fed. Reg. 21,637 (Apr. 11, 2012).

Predictive judgments. MetLife also encourages the Court to second-guess the Council's predictive judgments, a task beyond both the Court's purview and its expertise. In particular, MetLife argues that the FSOC, in connection with its review of MetLife's consultant Oliver Wyman, Inc.'s analysis of asset sales, improperly "assume[ed] even higher levels of stress and asset liquidation by MetLife" than Oliver Wyman did, and "fail[ed] to put forward its own projected scenarios or models," contrary to "accepted risk assessment practices." Compl. 36.

To the contrary, the FSOC did precisely what Congress envisioned an expert agency would do with an analysis of this type: The Council subjected the Oliver Wyman report to close testing based on a wide range of predictions about potential scenarios. For example, the FSOC carefully considered how asset sales caused by MetLife's financial distress could affect other large financial institutions. The Council's tests used methods established in both longstanding²² and post-crisis²³ academic research to evaluate Oliver Wyman's analysis of that question. The data and assumptions used in those tests, rather than "opaque," as the Complaint asserts, were described in detail in the FSOC's basis for its determination. *See* Final Basis, *supra*, at 331–34. And the tests demonstrated that the magnitude of the harm arising from a fire sale at MetLife

²² MetLife's quoted reference to the well-known technique of Monte Carlo simulation, *see* Compl. 36, and its suggestion that such analysis reflects "opaque and indefinite speculation," *id.*, is puzzling. Monte Carlo simulation involves testing complex problems by generating and evaluating potential outcomes; the outcomes are not produced completely at random but instead within given probabilities. This method has been established in the finance literature for at least forty years and has been applied to a wide variety of well-known problems in the field. *See* J.M. Hammersley & D.C. Handscomb, *Monte Carlo Methods* (1964); *see also, e.g.*, Phelim P. Boyle, *Options: A Monte Carlo Approach*, 4 J. Fin. Econ. 323 (1977) (applying this method to option-pricing problems).

²³ The Council's analysis, which considered the effects of asset sales related to significant and rapid decreases in the value of the firm's equity, is based in part upon a framework provided by a paper recently published in one of the premier peer-reviewed journals in finance research. *See* Final Basis, *supra*, at 329–40 (citing Robin Greenwood et al., *Vulnerable Banks*, 115 J. Fin. Econ. 471 (2015) (providing a model for asset sales caused by negative shocks to bank equity)).

could be greater than the harm caused by fire sales at all but nine other firms in the nation. *See id.* at 335, 337 tbl. 54.

To second-guess predictive judgments of this type would do more than improperly interfere with agency prerogatives. It would impose an evidentiary burden upon the FSOC's work that Congress did not intend the agency to bear. And it would significantly impede the Council's future efforts to safeguard the nation's financial system. This Court should decline MetLife's invitation to interfere with policy judgments designed to protect the American economy from the kind of devastation wrought by the last crisis—and the threat of the next one.

CONCLUSION

For all of the foregoing reasons, this Court should grant Defendant's motion to dismiss Plaintiff's complaint or, in the alternative, for summary judgment.

Dated: May 22, 2015

Respectfully submitted,

By: /s/ Kate Andrias

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CERTIFICATE OF SERVICE

I hereby certify that on this 22nd day of May, 2015, I electronically filed the foregoing Brief of Professors of Law and Finance as *Amici Curiae* Supporting Defendant with the Clerk of the Court via the CM/ECF system, causing it to be served electronically on all counsel of record.

Dated: May 22, 2015

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